

# Trends in Hours and Economic Growth\*

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October 2006 (first draft September 2005)

## Abstract

We study long-run trends in market hours of work and employment shifts across economic sectors driven by uneven TFP growth in market and home production. We focus on the substitutions between market and home production and on the structural transformation between agriculture, manufacturing and services. The model can rationalize the observed falling or U-shaped pattern for aggregate hours, the complete marketization of agriculture and manufacturing, and the shift from agriculture to services without violating balanced aggregate growth. We find support for the model's predictions in long-run US data.

**Keywords:** hours of work, labour supply, structural transformation, home production, marketization, balanced growth.

**JEL classification:** J21, J22, O14, O41

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\*We have benefited from suggestions and comments from Francesco Caselli, Jeremy Greenwood, Georgui Kambourov, James Heckman, Robert Lucas, Torsten Persson, Danny Quah, Valerie Ramey, Richard Rogerson, Randy Wright, Fabrizio Zilibotti and anonymous referees. We are especially grateful to Valerie Ramey for making available some of the data reported in Ramey and Francis (2006). An earlier version of this paper was presented as a keynote address at the CEPR/IZA annual labour economics conference at Ammersee in September 2005. We also acknowledge comments from presentations at the NBER meeting at the Cleveland Federal Reserve Bank, the IZA Prize Conference in Berlin, the SED conference in Vancouver, and several universities. We thank Eva Vourvachaki for research assistance. This study was financed by the ESRC under award no. RES-000-22-0917 and is part of the CEP's Research Programme in Macroeconomics. The CEP is a designated ESRC Research Centre.

A feature of modern economic growth is the changing trend in total hours of work. When industrialization first takes place hours of work outside the home are likely to increase, as more workers move to factories. Past this very early stage, total hours typically fall, largely as a result of a fall in the mean hours of those at work. In yet later stages of modern growth trends become less clear-cut, with no systematic overall dynamic pattern. In the United States the trend over the last century is a shallow U-shape, a long decline followed by a small rise. In other countries there is a monotonic decline, although one that flattens out as growth progresses. A “stylized fact” of low-frequency fluctuations in market hours during modern economic growth is a long-lasting decline in mean hours per head, which eventually dissipates. Figure 1 uses data from the website of the Groningen Growth and Development Centre and shows average weekly hours of work for the population of working age. We show data for 1960-2004 for the United States and the biggest European economies. The main fact of a declining trend that either slows down or reverses is evident. Even more striking is the decline in hours before 1960, in earlier stages of modern growth. Table 1 shows this decline from 1890 to 1960.<sup>1</sup>

The changing trends in aggregate hours that one finds in long runs of data are usually neglected by modern growth theory.<sup>2</sup> A seemingly unrelated feature of modern growth is structural transformation: the decline of agriculture and the rise of services, with relatively smaller changes in industrial employment. In this paper we propose a framework for the study of these two phenomena that builds on a common economic cause: the response of hours of work to the uneven distribution of technological change across production sectors located in the market and the home.<sup>3</sup>

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<sup>1</sup>In the United States the initial decline due to the fall in mean hours of those at work went on until about 1940, in most European countries until much later. The decline of agricultural employment also generally contributes to the decline of total hours, through the withdrawal of some workers from the labour force, especially women and children. In more recent times there has been an increase in the labour force participation of women in all industrial countries, which increased overall hours in the United States but not yet in the European countries, where hours per employee continued to fall. See Durand (1975, esp. ch. 4) and Maddison (1995) for cross-country evidence and Goldin (1995) for female labour supply in the US time series and in other countries. For the claim that in the very first stages of industrialization hours rise see Voth (1998).

<sup>2</sup>A typical statement is the following one, due to Cooley and Prescott (1995, p.16): “In balanced-growth consumption, investment and capital all grow at a constant rate while hours stay constant. This behavior is consistent with the growth observations described earlier.” See also the discussion in Gali (2005).

<sup>3</sup>Structural transformation has been studied by many authors. See Kuznets (1966) and Baumol (1967) for early contributions and Echevarria (1997), Kongsamut, Rebelo and Xie (2001) and Ngai and Pissarides (2004) for more recent work. Home production has been studied extensively in a partial equilibrium context, starting with Becker (1965) and Gronau (1977). More recently it has been studied in the context of equilibrium business cycles and to some extent in the context of growth (see Gronau 1997 for a survey and Parente, Rogerson and Wright 2000 and Gollin, Parente and Rogerson 2000 for growth-related work).

Table 1: Weekly hours of work, population of working age

Year	USA	France	Italy	UK
1890	35.9	39.7	43.4	35.4
1913	31.4	37.1	40.1	32.5
1929	27.3	32.0	32.0	26.9
1938	20.2	24.7	26.3	28.5
1960	23.8	25.1	24.2	28.5

The numbers shown are for the average weekly number of hours of market work for ages 15-64. Sources: Maddison (1995) for total hours and Mitchell (1980) and US Historical Statistics for the working age population.

In our model production can take place both in the market and the home. The time allocated to market production produces both consumption and capital goods and is a measure of the conventional supply of labour. The time allocated to home production produces consumption goods by using capital goods purchased in the market but it is not part of the conventional definition of labour supply. We show that because of the uneven distribution of technological change the division of total work time between market and home changes during the course of economic development. In our benchmark economy these changes drive the changes in aggregate labour supply. Under plausible conditions the time allocated to market production may increase initially, but as growth progresses it decreases. In later stages of economic growth it increases again. The prediction of a changing trend in the number of market hours is unique to our model: although a variety of mechanisms can yield a fall in market hours during economic growth, such as a rise in the returns to education or a rise in the demand for leisure, to our knowledge no model has been able to explain the turning point in market hours that we get from the substitutions between home and market production.

The intuition behind our results derives from the key assumption that although market activities at the disaggregation level of agriculture, manufacturing and services produce goods that are poor substitutes for each other, home production produces mainly goods that are close substitutes for goods produced in the market. Our utility function is defined over three composite goods, respectively corresponding to agricultural, manufacturing and service goods. Each composite is a basket of two goods, one of which is produced in the market and the other in the home. At the level of the composite goods employment is moving from agriculture and (eventually) manufacturing towards services, a process known as structural transformation. The reason is technology: because composite goods are poor substitutes for each other, employment moves to the sector with lowest TFP growth. But within each composite production is moving from the home to the market, a process that we call the marketization of home production. The reason for marketization is that TFP growth in the market is at least as high as TFP growth in the home, and given the high substitutability between the market- and

home-produced goods, production efficiency requires that work be transferred from the home to the market.

Combining the structural transformation and marketization forces we find that the home components of agricultural and manufacturing production, such as the cultivation of one's own food and the making of one's own clothes, lose hours fast over time because both forces work against them. In contrast, the home component of services, such as cooking and shopping, gain hours because of the structural transformation in favour of total services, but lose them because of marketization. The tension between these two forces drives the dynamics of overall market hours. It explains why home production of agricultural and manufacturing goods disappears quickly and why the home production of services may rise at first but fall later. Crucially for our purposes, it explains why early on market hours may rise - as the home production of agriculture and manufacturing is marketized; then they fall - as the structural transformation in favour of services moves production to the home; and finally may rise again - as the home production of services is marketized.

We summarize US historical evidence that shows that the home production of agricultural and manufacturing goods practically disappeared in the first quarter of the 20th century. When this happened there was still a lot of employment in agriculture, so there was still a large movement of labour from agriculture to services. As agricultural employment declined, the hours of work allocated to the home production of services increased, albeit less than the increase in the hours allocated to the market production of services, which also benefited from marketization. Examples of home production that gained hours include cleaning, household administration, shopping and child care (see section 1 for historical evidence). But eventually, as agricultural employment shrank and the home service production sector grew, the marketization force became larger and dominated the structural transformation force, bringing a fall in the size of the home production sector. This process can explain an inverted U-shape for home production hours and reflecting this, a U-shape for market hours. If, for reasons not specified in our model, initially women are more likely to engage in home production than men are, these dynamic patterns can explain the fall in male hours of work in the first half of the century and the rise in female employment in the second.

In our benchmark model we make the conventional assumption that non-work time (i.e., all time other than the hours allocated to market or home production) enters the utility function directly, and our utility function is such that in growth equilibrium non-work time is constant. During periods of transition to an aggregate balanced-growth equilibrium - following for example war or some other major event that disturbs the initial growth equilibrium - changes in non-work time also contribute to changes in aggregate labour supply, but these periods cannot explain the long swings in labour supply that is the topic of this paper. We report calibrations with the steady state of our model which show that in the United States at least, substitutions between market sectors and between the market and the home can explain virtually all of the dynamics

of sectoral employment shares and a significant part of the dynamics of market hours.

In an extension, however, we show how the model can yield a rising leisure time even when the economy is on a balanced growth path. The reason for pursuing this extension is that the substitutions between market and home do not explain the entire evolution in aggregate market hours, and it is plausible that some part of the big fall in hours of market work that has taken place since the beginning of the 20th century was matched by rising leisure. The idea behind this extension is to divide leisure time into two components, one that is the pure enjoyment of time, as in conventional theory, and one that is enjoyment of time obtained with the help of some capital input. In the first group there are activities like spending time with friends or playing with one's children. In the second there are activities like watching TV and surfing the net. The key difference between the second leisure component and home production is that home production produces goods that have close substitutes in the market, whereas leisure production has no close market substitutes. One cannot outsource TV watching time. We show that the extended model implies a rising "leisure production time," which gives a rising overall leisure time. Consequently, market hours either fall faster or rise less than in our benchmark model.

Ramey and Francis (2006) recently compiled US time series data for hours allocated to market production, home production and education since 1900. Consistent with our model predictions, they find a negative correlation between market hours and home hours.<sup>4</sup> With the help of more recent time use surveys, Freeman and Schettkat (2005) also find negative correlations between market hours and home hours for individuals, whereas Robinson and Godbey (1997) and Aguiar and Hurst (2005) find evidence of rising leisure. Our explanation of the recent rise in labour supply is consistent with this set of findings. It is, however, different from the one put forward by Greenwood, Seshadri and Yorukoglu (2005). Greenwood et al. argue that labour supply increased because of substitutions from labour to capital in the home, following a fall in the price of durable goods. In our model the price of durable goods also falls because of higher TFP growth in manufacturing than in services, but the substitution of capital for labour is not the driving force for the decline in home production time. The driving force is the marketization that takes place because similar goods can be produced more efficiently in the market (see also Rogerson, 2004, for a similar argument). Of course, the two explanations are not mutually exclusive. An example from Freeman and Schettkat (2005) that is consistent with our explanation is the observation that in the United States people consume more restaurant food than in Europe, where more food is prepared at home.<sup>5</sup>

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<sup>4</sup>They also find a negative correlation between market hours and education, given that their sample includes very young workers. We do not attempt to say anything about the rise in education in this paper.

<sup>5</sup>A full test of the merits of each hypothesis is beyond the scope of this paper. Two potential tests are (1) a detailed examination of the relation between the introduction of household appliances and the

Section 1 examines some of the history of home production in the United States and discusses what types of goods are produced at home. Section 2 describes in detail our benchmark model, paying particular attention to the marketization and structural transformation forces that shape the dynamics of hours. Section 3 discusses empirical implications and a numerical calibration based on US data on sectoral employment shares and aggregate market hours. Section 4 discusses an extension with a richer leisure model that gives more general results about the dynamic behaviour of aggregate labour supply.

## 1 What goods are produced at home?

Home production is defined as time spent on the production of goods and services, usually at home but sometimes outside, for one's own use. Two important properties of home production that distinguish it from leisure are (a) the individual derives utility from the output of home production but not from the time that she spends on it, and (b) home production can be "marketized", i.e., someone else can be paid to do it and the individual can still derive the same utility from its output. In contrast, leisure cannot be marketized, the individual has to spend the time herself to enjoy it.

It is important for our modelling that we know the relation between the goods produced at home and the goods produced in the market. The recent literature has focused mainly on aggregate models with one market good and one home-produced good, and argued convincingly that the two aggregates are close substitutes for each other.<sup>6</sup> Here we have three market goods, agricultural goods, manufactures and services. How are home-produced goods related to each one of these? The early literature on home production was concerned with these issues, and a lot of useful information can be obtained from it.<sup>7</sup>

Obvious home production activities are cleaning, cooking and child care. In the early stages of economic development people also grew their own crops, kept small farm animals, made clothes and preserved food (Leeds 1917, Reid 1934). The crops grown at home were close substitutes for the output of the agricultural sector, and the clothes and food preservation were substitutes for manufacturing goods. There is overwhelming evidence, however, that in modern industrial societies virtually all home production

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decline of paid domestic help. Were household appliances "engines of liberation" for the housewife or "engines of job destruction" for low skilled domestic labour? (2) A detailed examination of the behaviour of wages. In a decentralized economy our model would predict that women leave home production and join market production because female wages are rising. In the Greenwood et al. explanation the increased efficiency of home production releases time, which is now supplied to the market, so the impact should be from the increased supply of female labour to wages.

<sup>6</sup>The most commonly used substitution elasticities between the two are in the range 1.5-2.3. See Rupert, Rogerson and Wright (1995), McGrattan, Rogerson and Wright (1997), and Chang and Schorfheide (2003).

<sup>7</sup>See among others, Leeds (1917), Reid (1934), Vanek (1973) and Lebergott (1993).

produces goods that can only be classified as services. These activities include shopping, looking after children and other relatives and administration (keeping bank accounts, dealing with bills, etc.).

Contemporary writers argue convincingly that with urbanization home-grown crops and rearing of small animals for food disappeared as home economic activities, even for those who worked on the farms. Of course, it would be unreasonable to argue that farm owners and farm workers do not consume any of their own products. But these products are grown for the market and are not the output of home production. In the statistics on farm employment the time devoted to growing this component of own food consumption is counted as market work, and the most data-consistent way to interpret the consumption of crops by those employed on the farms is as payment in kind.<sup>8</sup>

The home production of manufacturing goods was also overtaken by modern manufacturing technology early on in the industrialization process. Reid (1934 p.45) made the point forcefully: “After 1800 economic conditions changed rapidly. Roads improved steadily. Trade increased. Modern inventions made the most efficient tools too expensive for small-scale household use. Steam power possible only for centralized industries brought about the withdrawal of much manufacturing from the home.” Some home manufacturing activities, however, survived into the twentieth century. Leeds (1917) writes that in his sample of 60 families in Pennsylvania, most families reported 2 to 3 hours a week making clothes for their own use. Although this included the work of paid domestic helpers, this was also an activity undertaken by the housewife.<sup>9</sup> But seventeen years later, Reid (1934, p.47) summarized as follows the then-state of household production: “As time went on, one form of production after another, spinning, weaving, ... and other [manufacturing] tasks have wholly or in part been transferred to commercial production. In addition, child care, education, and the care of the sick are now to a large extent carried on by paid workers.” In similar vein, Lebergott (1993, p.60) writes about the advent of “consumerism”, by quoting a 1932 paper by Viva Belle Boothe, as arguing that “modern industrial processes have robbed the home of almost every vestige of its former economic function.” Lebergott continued by noting that the remaining

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<sup>8</sup>See *Historical Statistics of the United States*, Chapter D on labour: “Employed persons comprise: (a) all those who, during the survey week, worked at all as paid employee, in their own business or profession or on their own farm.” Reid (1934, p. 48-51) argues that in the United States growing food specifically for own consumption disappeared as early as the 1920s. In the 1930 census of agriculture, the average proportion of total farm produce used by the operator’s family was 13.6%. But this was mainly market-grown food. “Home production farms”, by which we mean small holdings that the owners used primarily to grow their own food, amounted to a mere 8% of all farms. Reid calls these “self-sufficing farms” and defines them as farms that the owners consumed over 50% of output. In 1929 the average proportion of own consumption on these farms was 66.1%.

<sup>9</sup>The total weekly hours of work in the household by the “housewife and her assistants, whether hired or members of the family” is 101.75 hours. 5.75 hours were spent on making clothes, and the rest were spent on activities classified as services. See Leeds (1917, p.67).

home work “consists largely of services.”<sup>10</sup>

As the home production of agricultural and manufacturing substitutes went into decline, the home production of services increased. Mokyr (2000) writes that at the beginning of the 20th century there was an increased demand for cleaner homes and better-prepared food, which required more home-production time. This is consistent with observations made by Leeds (1917, p. 70), who described approvingly the experience of “a bright young woman” in whose household “The hours given to cleaning are few, because her house has all hard-wood floors covered with rugs; dishes are washed only once daily (immediately after breakfast) and not wiped.” Clearly, such standards of cleanliness became unacceptable later in the century. The types of tasks done at home also changed over the century. Vanek (1973, p. 111) finds that “there has been a reallocation of the tasks of household work ... a shift from maintenance and production to managerial and interactional tasks.” Shopping is another home production service that became increasingly prominent during the 20th century (Lebergott 1993, Robinson and Godbey 1997).

The principal current home-production activities in the United States are shown in Table 2. As expected, these are all activities whose products are classified as services and which have close substitutes in the market services sector. No item in present-day time use surveys, either in Europe or elsewhere in the industrialized world, lists an activity that yields products that can be classified as either agricultural or manufacturing goods. The biggest item in the American surveys is shopping, followed by caring for other people in and out of the household (presumably children and parents or relations living elsewhere). Moreover, although the time devoted to sub-categories changed over time, the broad categories of activities have not changed significantly since the 1930s.

In view of the historical evidence and evidence from modern time-use surveys, a good model of the allocation of time has to explain the reasons that home agricultural and manufacturing production have disappeared in modern industrial societies. It also has to explain why service production at home is surviving in such big numbers. We now describe such a model. As anticipated by the early writers, the driver is technology.

## 2 A growth model with trends in hours

Our argument can be developed in a simplified model where market work takes place in three differentiated sectors. An extension to more sectors is straightforward, at some no-

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<sup>10</sup>The number of home production hours that Lebergott reports are out of line with the numbers reported by others, most likely because of differences in the treatment of home production hours by paid domestic assistants. As Ramey and Francis (2006) note, assistants’ hours should be part of market hours, because they are paid for, but Lebergott included them in home production time. There is no disagreement, however, about the type of activities performed at home and reported by Lebergott, which is the evidence that we cite here. In our model hours by paid domestic assistants are market hours.



Table 2: Weekly hours of home production, American Time Use Survey

Activity	Hours	Activity	Hours
Housework	4.23	Purchasing goods and Services	5.67
Food preparation and clean up	3.64	Caring for household members	3.83
Garden care	1.36	Caring for non-household members	1.96
Household management	0.95	Total	21.64

The numbers shown are for the average weekly number of hours of home work for the population aged 15 and over for 2003 and 2004. Source: Bureau of Labor Statistics, <http://www.bls.gov/tus/>, Table 1.

tational cost. Agriculture and services produce only consumption goods. Manufacturing produces the economy's capital stock and a consumption good. Home production can also produce three consumption goods with differentiated technologies, each of which is a good substitute for each of the consumption goods produced in the market. Capital goods cannot be produced in the home. Time has three uses - it can be used in market production, in home production or in leisure.<sup>11</sup>

We derive the equilibrium as the solution to a social planning problem that maximizes the utility function of a representative agent. Equilibrium is defined as a set of dynamic paths for the allocation of capital and time to the three market sectors, home production and non-work time (leisure), and the allocation of the output of each sector to consumption and capital. The utility function of the infinitely-lived representative agent is

$$U = \int_0^{\infty} e^{-\rho t} [\ln \phi(.) + v(1 - l)] dt \quad (1)$$

where  $l \in (0, 1)$  are per capita hours of total work (market and home),  $v(.)$  is the utility of leisure, with  $v' > 0$ ,  $v'' < 0$ , and  $v' \rightarrow \infty$  as  $l \rightarrow 1$ , and  $\phi(.)$  is a CES aggregate over final consumption goods, defined by:

$$\phi(.) = \left( \sum_{i=a,m,s} \omega_i c_i^{(\varepsilon-1)/\varepsilon} \right)^{\varepsilon/(\varepsilon-1)}. \quad (2)$$

$c_i$  is the per capita consumption of a composite good, one each for agriculture, manufacturing and services,  $\varepsilon > 0$  is the elasticity of substitution between these composites,

<sup>11</sup>Thus we ignore the biggest fraction of the week, which is spent on essential physiological activities, mainly sleep, and which shows remarkable stability over time and across countries (about 70 hours). We also ignore schooling. See Juster and Stafford (1991) and Robinson and Godbey (1997).

and  $\omega_i > 0$ ,  $\sum \omega_i = 1$ . The consumption composites are combinations of the output of the market and home sectors for each good, respectively distinguished by a second subscript,  $j = m, h$  :

$$c_i = \left[ \psi_i c_{im}^{(\sigma_i-1)/\sigma_i} + (1 - \psi_i) c_{ih}^{(\sigma_i-1)/\sigma_i} \right]^{\sigma_i/(\sigma_i-1)} \quad i = a, m, s. \quad (3)$$

Here,  $\psi_i \in (0, 1)$ ,  $c_{ij} \geq 0 \quad \forall i, j$  and  $\sigma_i > 0$ . The restrictions on the utility function are a combination of sufficient restrictions consistent with steady-state growth when leisure is endogenous and there are many consumption goods, previously derived by King et al. (1988) and Ngai and Pissarides (2004).

A key assumption is

$$R1 : \sigma_i > 1 > \varepsilon \quad \forall i. \quad (4)$$

It implies that market and home-produced goods are close substitutes for each other but the agricultural, manufacturing and service goods are not close substitutes for each other. Generally, the three composite goods are distinct goods that households want to consume in near-constant proportions, but within each composite goods are only marginally differentiated and larger substitutions take place. We discuss some more evidence supporting *R1* in section 3.2.

Our measure of total time is the total time available to the population who can work. We let  $l_{ij}$  denote the time allocated to each of the six production activities. Total market employment is  $\sum_i l_{im} \equiv q$ , which, in the absence of unemployment, is also the conventional definition of aggregate labour supply. Market employment shares are then defined by  $l_{im}/q$ , for  $i = a, m, s$ . Facts about the aggregate labour supply are statements about the evolution of  $q$ , whereas structural change refers to changes in the market shares  $l_{im}/q$ .

Production functions are identical in all activities except for their TFP parameters  $A_{ij}$ , which are Hicks-neutral:

$$F^{ij} = A_{ij} F(l_{ij} k_{ij}, l_{ij}); \quad \dot{A}_{ij}/A_{ij} = \gamma_{ij} \quad i = a, m, s, \quad j = m, h. \quad (5)$$

The production function  $F$  has constant returns to scale, positive and diminishing returns to inputs, and satisfies the Inada conditions;  $k_{ij}$  is the capital-labour ratio and  $A_{ij}$  is TFP in each sector, with growth rate  $\gamma_{ij}$ .

All sectors produce consumption goods but only manufacturing produces capital goods. For convenience we split manufacturing into two sub-sectors, one producing consumption goods and the other producing only capital goods, with the same technology. With some abuse of notation we distinguish by subscripts  $mm$  the component used in the production of consumption goods only and by  $mk$  the component used in the production of capital goods. Because we are assuming constant-returns technologies and free factor mobility, this is equivalent to assuming one manufacturing sector whose output can be

either consumed or invested:

$$c_{im} = A_{im}l_{im}f(k_{im}) \quad i = a, m, s, \quad (6)$$

$$c_{ih} = A_{ih}l_{ih}f(k_{ih}) \quad i = a, m, s, \quad (7)$$

$$\dot{K} = A_{mm}l_{mk}f(k_{mk}) - (\delta + \nu)K, \quad (8)$$

$$\sum l_{ij} = l, \quad i = a, m, s, \quad j = m, h, k, \quad (9)$$

$$\sum l_{ij}k_{ij} = lk, \quad i = a, m, s, \quad j = m, h, k; \quad (10)$$

where in general  $f(k) \equiv F(k, 1)$ ,  $\delta$  is the capital depreciation rate,  $\nu$  is the population growth rate,  $k$  is the ratio of the capital stock to hours of “total work” (the sum of market and home hours) and  $K$  is the ratio of the aggregate capital stock to the population (so  $k = K/l$ ).

We obtain optimal allocations by maximizing the utility function in (1) subject to (5)-(10). The maximization can be described over three layers. At the highest level, the agent chooses a path for aggregate consumption (essentially for our composite  $\phi$ ), hours of total work and the aggregate capital stock. Next, the aggregate capital stock and total work are allocated to the production of the three consumption composites  $c_i$  ( $i = a, m, s$ ) and the capital stock. And finally, the allocation to each  $c_i$  is divided between market and home production. The conditions giving the allocations in the last two layers are “static”. We start with the lowest level, the division of the allocation to each  $c_i$  between home and market, and move to the highest.

## 2.1 Optimal allocations between market and home: marketization

Suppose that the agent has allocated labour  $l_i$  and capital per hour  $k_i$  to the production of consumption composite  $c_i$ . What is the optimal allocation of these between home and market production? To find the answer we maximize (3) separately for each  $i$  subject to the production functions in (6) and (7) and:

$$l_i \geq l_{ih} + l_{im}, \quad (11)$$

$$l_i k_i \geq l_{ih} k_{ih} + l_{im} k_{im}. \quad (12)$$

Optimal allocations satisfy the first-order conditions

$$\frac{\psi_i}{1 - \psi_i} \left( \frac{c_{im}}{c_{ih}} \right)^{-1/\sigma_i} = \frac{A_{ih}}{A_{im}}, \quad (13)$$

$$k_{im} = k_{ih}. \quad (14)$$

Free capital and labour mobility imply that production efficiency is achieved at all times with equal capital-labour ratios between the home and the market. We can therefore

drop the second subscript and write  $k_i$  for the common capital-labour ratio in sector  $i$  (in manufacturing it will also be optimal to have the same capital-labour ratio in the production of capital goods, as we show below). Making use of the production functions and (13)-(14) we obtain:

$$\frac{l_{ih}}{l_{im}} = \left( \frac{1 - \psi_i}{\psi_i} \right)^{\sigma_i} \left( \frac{A_{im}}{A_{ih}} \right)^{1 - \sigma_i}. \quad (15)$$

Equation (15) contains the important “marketization” result of this paper: Because the relative TFP levels are changing over time, the employment shares in market and home production are also changing. By differentiation with respect to time we obtain:

$$\frac{\dot{l}_{im}}{l_{im}} - \frac{\dot{l}_{ih}}{l_{ih}} = (\sigma_i - 1)(\gamma_{im} - \gamma_{ih}). \quad (16)$$

With  $\sigma_i > 1$ , and if TFP in the market sector is rising faster than in the home sector, the home sector is losing labour to the market sector. It implies that if the TFP growth rate of the market sector remains above the TFP growth rate of the home sector for a sufficiently long time, eventually the home sector will vanish and all consumption goods will be produced in the market. This is the basis of our claims about the marketization of all home production of agricultural and manufacturing goods. We return later in the paper to a discussion of the conditions needed for these results and to the question of the marketization of service production.

From (15) we obtain the share of home production in composite good  $i$  :

$$\frac{l_{ih}}{l_i} = \frac{\left( \frac{1 - \psi_i}{\psi_i} \right)^{\sigma_i} \left( \frac{A_{ih}}{A_{im}} \right)^{\sigma_i - 1}}{1 + \left( \frac{1 - \psi_i}{\psi_i} \right)^{\sigma_i} \left( \frac{A_{ih}}{A_{im}} \right)^{\sigma_i - 1}}. \quad (17)$$

We give it here for future reference.

## 2.2 Optimal sectoral allocations: structural transformation

We now consider optimal allocations at the level of the composite sector. The analysis of the preceding section enables us to implement a convenient aggregation. Making use of (13) and (3), we derive the optimal relation between the consumption composite  $c_i$  and the part of it produced in the market:

$$c_i = z_i^{\sigma_i} c_{im} \quad (18)$$

$$z_i \equiv \psi_i^{1/(\sigma_i - 1)} \left[ 1 + \left( \frac{1 - \psi_i}{\psi_i} \right)^{\sigma_i} \left( \frac{A_{ih}}{A_{im}} \right)^{\sigma_i - 1} \right]^{1/(\sigma_i - 1)}. \quad (19)$$

We note that  $z_i$  depends only on parameters and it is a function of time because of its dependence on the ratio of home to market TFP. Similarly, from (15) we can write the aggregate  $l_i$  allocated to sector  $i$  in terms of the market allocation:

$$l_i = l_{im} + l_{ih} = \psi_i^{-1} z_i^{\sigma_i - 1} l_{im}. \quad (20)$$

Therefore, we can aggregate the production functions in (6) and (7) into one for the composite  $c_i$  :

$$c_i = \psi_i z_i A_{im} l_i f(k_i) \quad i = a, m, s. \quad (21)$$

Maximization at the level of the sector takes place by maximizing  $\phi(\cdot)$  in (2) for given  $l$  and  $k$ , with controls  $c_i, l_i, k_i, l_{mk}$  and  $k_{mk}$ . The constraints are (21) and as before, (8)-(10), noting that  $l_{im} + l_{ih} = l_i$  and  $k_{im} = k_{ih}$ .

Maximization with respect to the factor inputs yields

$$k_{mk} = k_i = k \quad i = a, m, s, \quad (22)$$

so capital-labour ratios are common in all production activities. Maximization over the consumption allocations yields,

$$\frac{\phi_i}{\phi_j} = \frac{\psi_j z_j A_{jm}}{\psi_i z_i A_{im}} \quad i, j = a, s, m, \quad (23)$$

where the notation is in general  $\phi_i \equiv \partial\phi/\partial c_i$ . Given the definition of  $\phi$  in (2), we can write

$$\frac{c_i}{c_j} = \left( \frac{\omega_i \psi_i z_i A_{im}}{\omega_j \psi_j z_j A_{jm}} \right)^\varepsilon, \quad (24)$$

and from this equation and (21) we can get:

$$\frac{l_i}{l_j} = \left( \frac{\omega_i}{\omega_j} \right)^\varepsilon \left( \frac{\psi_j z_j A_{jm}}{\psi_i z_i A_{im}} \right)^{1-\varepsilon}. \quad (25)$$

This equation is the basis of the structural transformation force. Traditionally, structural transformation is discussed in the context of market hours of work only. For market hours the equation is derived from (25) by making use of (17):

$$\frac{l_{im}}{l_{jm}} = \left( \frac{\omega_i \psi_i}{\omega_j \psi_j} \right)^\varepsilon \frac{z_j^{\sigma_j - \varepsilon}}{z_i^{\sigma_i - \varepsilon}} \left( \frac{A_{jm}}{A_{im}} \right)^{1-\varepsilon}. \quad (26)$$

We note that if there is no home production of goods  $i$  and  $j$ , i.e., if  $\psi_i = \psi_j = 1$ , then  $z_i = z_j = 1$ , equations (25) and (26) become identical and the structural transformation force is:

$$\frac{\dot{l}_i}{l_i} - \frac{\dot{l}_j}{l_j} = (1 - \varepsilon)(\gamma_{jm} - \gamma_{im}). \quad (27)$$

For  $\varepsilon < 1$ , sectors with fast TFP growth are losing labour to sectors with low TFP growth, unlike the marketization force, which gives a movement in the opposite direction.

When there is home production the dynamics of  $z_i$  also matter in sectoral allocations. By differentiation of the expression for  $z_i$  in (19) we obtain:

$$\frac{\dot{z}_i}{z_i} = (\gamma_{ih} - \gamma_{im}) \frac{\left(\frac{1-\psi_i}{\psi_i}\right)^{\sigma_i} \left(\frac{A_{ih}}{A_{im}}\right)^{\sigma_i-1}}{1 + \left(\frac{1-\psi_i}{\psi_i}\right)^{\sigma_i} \left(\frac{A_{ih}}{A_{im}}\right)^{\sigma_i-1}} \quad (28)$$

$$= (\gamma_{ih} - \gamma_{im}) \frac{l_{ih}}{l_i}, \quad (29)$$

where use has been made of (17). Bringing now results together, by differentiating (25) with respect to time and making use of (29), we obtain:

$$\frac{\dot{l}_i}{l_i} - \frac{\dot{l}_j}{l_j} = (1 - \varepsilon) (\gamma_j - \gamma_i) \quad i, j = a, m, s. \quad (30)$$

$$\gamma_j \equiv \left(1 - \frac{l_{jh}}{l_j}\right) \gamma_{jm} + \frac{l_{jh}}{l_j} \gamma_{jh}. \quad (31)$$

A comparison with (27) shows that when there is a home sector the TFP growth rates of the market sectors are replaced by the weighted average of the TFP growth rates of the market and home sectors. It is clear from the definition of  $\gamma_j$  that we need some quantitative restrictions on TFP growth rates to sign the direction of labour movement. We return to this question in section 3.

We now solve for the sectoral distribution of employment and capital for given aggregate  $l$  and  $k$ . From (22), capital is distributed such that capital-labour ratios are equal in all sectors. But given  $k_{mk} = k$ , employment in the capital-producing sector is immediately obtained by inverting the production function, since the output of the sector is given by the assumption, made so far, that the path of the aggregate capital stock is given. Therefore, the distribution of employment in the consumption-producing sectors satisfies equations (25) for a given total allocation of time  $l - l_{mk}$ . The solution for each sector's employment follows immediately:

$$\frac{l_i}{l - l_{mk}} = \frac{\omega_i^\varepsilon (\psi_i z_i A_{im})^{-1+\varepsilon}}{\sum_j \omega_j^\varepsilon (\psi_j z_j A_{jm})^{-1+\varepsilon}} \quad (32)$$

With knowledge of  $l_i$  the hours of work in market and home production are obtained from (20), completing the description of equilibrium at this level.

## 2.3 Aggregate growth

Aggregate equilibrium is obtained by defining per capita aggregate consumption of all goods in terms of the manufacturing market price. The objective is to aggregate up

from the composite goods such that the utility function (1) and dynamic constraint (8) become functions of aggregate consumption, the aggregate capital stock and non-work time.

We first obtain the aggregate utility function. Because of the competitive allocations that we have assumed, the price of consumption composite  $i$  in terms of the manufacturing market price is equal to the marginal rate of substitution  $\phi_i/\phi_{mm}$ . We define aggregate per capita consumption as follows:

$$c \equiv \sum_{i=a,m,s} \left( \frac{\phi_i}{\phi_m} \right) \left( \frac{\phi_m}{\phi_{mm}} \right) c_i. \quad (33)$$

The first MRS is obtained from (23) and the second by differentiation of (2) and (3) and use of (18). The relative price of composite  $i$  to the manufacturing market price that we obtain is  $A_{mm}/(\psi_i z_i A_{im})$ . From (21) we then derive:

$$c = A_{mm} f(k) (l - l_{mk}). \quad (34)$$

From (21) again and (32) we obtain

$$\frac{c_i}{c} = \frac{(\omega_i \psi_i z_i A_{im})^\varepsilon}{A_{mm} \sum_{\forall j} \omega_j^\varepsilon (\psi_j z_j A_{jm})^{\varepsilon-1}}. \quad (35)$$

We use (35) to substitute all  $c_i$  out of  $\phi$ . Because  $\phi$  is homogeneous of degree 1 we can write  $\phi = c \tilde{\phi}(\cdot)$ , where  $\tilde{\phi}(\cdot)$  is a function of parameters (albeit changing over time).

The aggregate constraints are (34), the definition  $k = K/l$ , and (8). We substitute (34) into (8) to obtain the single constraint that describes the evolution of the aggregate state variable:

$$\dot{K} = A_{mm} l f(K/l) - c - (\delta + \nu) K. \quad (36)$$

We also define the new maximand, derived from (1) and  $\phi(\cdot) = c \tilde{\phi}(\cdot)$ ,

$$\tilde{U} = \int_0^\infty e^{-\rho t} [\ln c + v(1-l)] dt. \quad (37)$$

Aggregate equilibrium is defined as the paths of  $c, l$  and  $K$  that maximize (37) subject to (36).

Inspection of the maximization problem shows that it has the structure of the maximization problem of the one-sector Ramsey economy, except for one difference: technological growth in the Ramsey economy needs to be labour-augmenting but here it is Hicks-neutral. We therefore assume that the production function is Cobb-Douglas, which make the two equivalent:  $f(k) = k^\alpha$ . Under this assumption there are unique convergent paths for  $c, l$  and  $K$  and a balanced-growth equilibrium with  $l$  constant and  $c$  and  $K$  growing at the rate of labour-augmenting productivity growth in manufacturing,  $\gamma_{mm}/(1-\alpha)$ . Once the equilibrium paths for the aggregates are known, the rest of

the model is solved by working backwards through our derivations: the evolution of the consumption composites is given by (35) and their breakdown between home and market consumption by (18). The capital-labour ratio in all production activities is given by  $k = K/l$  and the evolution of hours of work used in the production of capital goods by (8). With knowledge of  $l$  and  $l_{mk}$ , (32) gives employment in the production of each composite good  $i$  and (17) gives its breakdown between home and market, completing the description of equilibrium.

### 3 Empirical implications and other properties

#### 3.1 Qualitative properties and aggregate facts

It is straightforward to show with standard techniques that the stationary equilibrium of the aggregate maximization problem is saddlepath-stable. In a diagram with hours of work on the vertical axis and capital per efficiency unit on the horizontal axis the saddlepath is downward-sloping, which implies that starting with low capital, in the adjustment to equilibrium hours of work are falling. But given our interest in long-run trends, it is more interesting to look at the properties of steady-state equilibrium. On the steady state hours of total work are constant. We still get changing hours of market work which are compensated by changes in hours of home production.

There is a close relation in our model between consumption and non-work time, given by

$$\frac{c}{y} = \frac{1 - \alpha}{v'(1 - l)l}, \quad (38)$$

where  $y$  is aggregate per capita output, defined analogously to aggregate per capita consumption, in terms of the manufacturing market price:

$$y = c + A_{mm}l_{mk}k^\alpha = A_{mm}lk^\alpha. \quad (39)$$

Since in this expression  $A_{mm}k^{\alpha-1}$  is constant in the steady state,  $l_{mk}$  must also be constant and  $y, c$  and  $k$  must grow at the same rate. So the following allocations are constant in our steady state: total hours of work allocated to the production of consumption goods, total hours allocated to the production of capital goods and total hours of non-work time. But market hours are defined by  $q \equiv \sum_i l_{im} + l_{mk}$ , and so are changing over time.

If we restrict attention to the market sector, we find that the capital-output ratio is also constant and output per hour is growing at constant rate. The aggregate capital stock in the market sector is given by

$$K_{market} = \sum_i (l_{im} + l_{mk})k = qk, \quad (40)$$



and so the market capital-labour ratio,  $K_{market}/q$ , is simply  $k$ . Market output is

$$y_{market} = \sum_i \left( \frac{\phi_{im}}{\phi_{mm}} \right) A_{im} k^\alpha l_{im} + A_{mm} k^\alpha l_{mk} = q A_{mm} k^\alpha \quad (41)$$

and so market output per hour,  $y_{market}/q$  is growing at the same constant rate as the other aggregates. The capital-output ratio in the market economy is constant. This confirms our claim that our economy satisfies Kaldor's stylized facts of aggregate balanced growth, despite the changes in labour supply.

We now discuss some important qualitative properties of hours of work by making the following assumptions on productivity growth rates:

$$\begin{aligned} R2m & : \gamma_{am} \geq \gamma_{mm} > \gamma_{sm} \\ R2h & : \gamma_{im} \geq \gamma_{ih} \quad \forall i. \end{aligned}$$

*R2m* is consistent with the observed fact that the price of services is rising faster, and the price of agricultural goods slower, than the price of manufacturing goods. It is also consistent with the direct estimates of Jorgensen and Gallop (1992) for the period 1947-85 and Jorgensen and Stiroh (2000) for 1959-1995. *R2h* is more difficult to justify with hard empirical evidence, but it can be justified on the grounds that the market can replicate a home technology but not vice versa. Anecdotal evidence in its favour abounds, as for example the statements by Reid (1934) and others cited in section 1 for manufacturing.

Assumption *R2h* implies that over time the home production of goods should be transferred to the market. Equation (16) shows that the marketization force is stronger the closer substitutes home-produced goods are to market-produced goods and the bigger the difference between their TFP growth rates. Assumption *R2m* and (27) imply that in the absence of home production agriculture should be losing hours to manufacturing and services, and manufacturing should be losing hours to services. A sufficient condition that home production does not reverse the direction of structural change dictated by the market TFP levels is that the differentials  $\gamma_{im} - \gamma_{ih}$  have the same ranking as the market TFP growth rates, which is plausible. But because the weight of the home sector in the  $\gamma_j$  of the composites becomes progressively smaller over time through the marketization force, there is a point after which the market TFP growth rates dominate in the evolution of employment shares whatever the ranking of the home TFP levels.

The evidence that we examined in section 1 indicated that the home production of agricultural goods in the United States virtually disappeared by 1930. This suggests that home production of agricultural goods has had too small a share in overall agricultural employment to make a difference to the structural transformation out of agriculture, and at least since 1930 we can assume that the number of hours allocated to agricultural home production is practically zero. Similarly, the evidence on the home production of manufactured goods is that by 1930 it was overtaken by market production because of

technological improvements in the market. This mechanism is precisely the one in our model. As with agriculture, it again suggests that after industrialization, the home sector in manufacturing became too small to make a difference in the employment reallocations dictated by market TFP levels across sectors.

But time use surveys show substantial home production of services. Why did agricultural and manufacturing home production vanish so fast and yet service home production is surviving in such big numbers? The reason is found in the way that the marketization and structural transformation forces combine to cause sector employment dynamics. Looking at agriculture, we argued that it has the highest TFP growth rate, so the sector overall is losing hours at fast rate. Moreover, the output of home production and market production are likely to be very close substitutes, and TFP in the market, because of economies of scale, is likely to be growing much faster than the TFP of food production at home. So in agriculture both the marketization force and the structural transformation force are strong and both work against home production, which as a result disappears fast.

Similarly in manufacturing, the output of the home sector is likely to be a very close substitute to the output of home production (e.g., home-made versus ready-made clothes), and technology in the market has risen much faster than in the home after the industrial revolution. For both these reasons, the marketization force in manufacturing is likely to be strong. But manufacturing as a whole gains labour from agriculture, so at least when there is a substantial agricultural sector, the structural transformation force is not strongly against manufacturing home production. In the early stages of industrialization there is a tension between the two forces in the home production of manufacturing goods, the transformation out of agriculture pushing for a rise in both market and home hours and technological improvements in the market pushing for a rise in market hours and a fall in home hours. Eventually, however, and as the share of agricultural employment shrinks, manufacturing as a whole has to lose labour to services. So although we may not see the home production of manufacturing goods fall rapidly at first, it should be marketized fast during the industrialization process. We argued in section 1 that early time use surveys show some home production of manufacturing goods in the very early part of the 20th century, when the home production of agricultural goods had for practical purposes vanished. But most of the home production of manufacturing was marketed much before the turn of the century and by 1930 it had practically vanished.

In contrast to agriculture and manufacturing, market-produced services are not likely to be as close a substitute for home-produced services. Whereas the outputs of agriculture and manufacturing are “standardized,” service output is more diverse. For example, child care, looking after needy relatives and shopping for one’s own clothes are not standardized activities that have very close substitutes provided by the market. Equally importantly, because TFP growth in the production of market services is low, the marketization force for home services is weak. Opposing this weak force against home hours,

there is a strong structural transformation force increasing hours of total work spent on services. The net effect on home-produced services is ambiguous, but if it is positive, it is so when agriculture or manufacturing are shedding a lot of labour, which makes the structural transformation force stronger. Eventually, when the structural transformation force weakens through the diminishing importance of agriculture and manufacturing, the marketization force takes over, leading to a shrinkage in the home sector. So in contrast to home-produced food and manufacturing goods, we should observe a non-monotonic, most likely hump-shaped path for hours of work spent on home-produced services. Moreover, the marketization of home services is weak, and so the fall in home hours in the later stages of economic growth is likely to be slow, because of both a small substitution elasticity and small productivity-growth differentials between market and home. Sub-sectors within services that have either no close substitutes in the market or have practically zero TFP growth in both the market and the home, such as aspects of child care, may never marketize completely.

Figure 2 is for the United States and shows the trends in market hours of work and in the market employment shares of the three industrial sectors.<sup>12</sup> Our model's predictions are consistent with the broad trends that we see in the figure. The evolution of the sectoral shares is consistent with the assumptions of low substitutability between their final products and the ranking of their TFP growth rates. Manufacturing employment does not fall as rapidly as agricultural employment because it produces capital goods that are needed by the expanding (market and home) service sector. More interestingly, our model's predictions are consistent with what we see in total market hours. In the early part of the twentieth century the home production of all goods is still active and the employment share of agriculture is high. Both the marketization and structural transformation forces are strong and acting in opposite directions, so the outcome on the evolution of market hours is ambiguous. According to our model, in this period the home production of agriculture and manufacturing should be losing hours fast but the home production of services should be gaining them. In the middle years, which cover the middle two quarters of the century, the home production of agricultural and manufacturing had practically disappeared, but the structural transformation force out of agriculture was still strong because of the relative size of this sectors. The prediction of our model is that the structural transformation force should dominate the marketization of services, and so the hours allocated to the home production of services should be rising and total hours of work falling. This is consistent with what we see in the figure.

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<sup>12</sup>The series for market hours in figure 2 is not the same as the one shown in figure 1, which is for comparable cross-country data, because of differences in coverage. The series shown in figure 2 are due to Ramey and Francis (2006) and are more general. They include unpaid family workers, the self-employed, government employment and commuting time (which is a constant 10 percent of the sum of the previous three). We are grateful to Valerie Ramey for sending us these data. We divided the total hours of market work by the population over age 10, because in the early years many children aged 10 and above worked in the market. However, our results are not affected by the choice of denominator.

But eventually the structural transformation force weakens because of the shrinkage of agricultural employment, and the marketization of services takes over. The impact on overall market work should be a rise in hours, especially by women, who performed the home tasks before marketization.

## 3.2 Quantitative implications

Having established that under restrictions  $R1$ ,  $R2m$  and  $R2h$  the broad trends in the data are qualitatively consistent with the model's predictions, we investigate here more closely its quantitative implications. We compare our model's predictions with the US time series under the assumption that the economy is on the steady state that solves the maximization of (37) subject to (36). This restriction implies that we focus here on substitutions between market and home production for trends in overall market hours and on substitutions between all three goods for the sectoral allocations. How much of the evolutions in the data can these substitutions explain?

In order to answer this question the model requires, (1) an initial allocation of hours to the six production technologies; (2) four elasticities of substitution,  $\varepsilon$  and  $\sigma_i$  for  $i = a, m, s$ ; (3) five TFP growth differences,  $\gamma_{am} - \gamma_{mm}$ ,  $\gamma_{mm} - \gamma_{sm}$  and  $\gamma_{im} - \gamma_{ih}$  for  $i = a, m, s$ ; and (4) the steady-state investment rate,  $\eta$ , which gives the employment share of capital production. However, as we argued in the preceding section, home production of agricultural and manufacturing goods virtually disappeared by the late 1920s. This is important for us because the most difficult data to get are the parameters and initial distributions pertaining to home production in the early years of the century. Another important data limitation in the earlier years is service-sector productivity. We use relative prices to compute TFP trend differentials but a comprehensive data series for service goods prices is available only for the period since 1929. In view of these data limitations we trust more the performance of the model in the post-1929 period. We focus on this period but we also make what we can of the earlier data and report calibrations for 1900-1929.

*Initial allocations.* The annual series for market shares and total market hours that we use to extract initial distributions are shown in figure 2. We obtained the initial allocation to home production from the data provided by Ramey and Francis's (2006).<sup>13</sup> Ramey and Francis did not distinguish between types of activities done at home but for the simulations beginning in 1930 we can assume that these activities were exclusively service activities. Early studies confirm that the vast majority of activities at the turn of the century were also service activities, but some manufacturing-type tasks and food growing or domestic animal care were also reported. Given the data limitations, the best we can hope for in distinguishing between different uses of home production time in

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<sup>13</sup>Because home hours in the early period may not be accurately measured, we also experimented with initial values that are  $\pm 20$  per cent of the Ramey-Francis data, with virtually no impact on our predictions (the impact was too small to show on the graph below).

the first quarter of the century is some approximate fraction of time initially allocated to manufacturing and agricultural activities. The strength of the model will be to show that whatever that allocation turns out to be, reasonable parameter values imply that it virtually disappeared by the late 1920s.

As we saw, Leeds (1917) reports that in 1912-13 families in his Pennsylvania sample spent about 5 per cent of their home work time (which included time spent by paid assistants) making or mending clothes. They also spent smaller amounts of time on carpentry but he does not give figures for this activity, as the number of hours reported was too small. We could not find other pertinent data for this activity. As Leeds' sample was better off than the median, this may be treated as a lower bound on the fraction of home production time devoted to making goods.

The time of home production devoted to food production is more difficult to measure and to our knowledge there is no study that gives even approximate figures. Urban families report virtually no time spent on food production or animal care. Rural families report some hours a week during which the housewife works on the farm, but the main activities listed are tasks like washing milk containers and looking after small animals. Vanek (1973) reports 10 hours a week on these activities by rural housewives but lists them separately from home-making. This also appears to be the practice with other researchers. In the official statistics and in Kendrick (1961), which is the main source of market hours used by Ramey and Francis (2006) for the early period, the hours allocated to such activities come under "unpaid family workers" and so are included in market hours. The Ramey-Francis home production data do not contain any hours allocated to the growing of food and looking after animals for own consumption. In view of this we cannot attribute part of the total home-production time that we use to the production of agricultural substitutes, in any part of the century. As an illustration, we report below the speed at which agricultural home production is marketized at plausible elasticity values, but we do not include this in the main calibrations.

*Elasticities of substitution.* The parameter  $\sigma_s$  is the elasticity of substitution between service and home goods. Estimates in the literature are for recent times and they are for the elasticity of substitution between aggregate market goods and home production. They are in the range 1.5 to 2.3 (see Rupert, Rogerson and Wright 1995, McGrattan, Rogerson and Wright 1997 and Chang and Schorfheide 2003). As in more recent times all home production is of service goods, and in our model  $\sigma_s$  is the elasticity of substitution between home goods and a smaller set of goods than estimated, our  $\sigma_s$  should be at least as large as the existing estimates. We choose the biggest of these estimates,  $\sigma_s = 2.3$ .

The elasticity of substitution for manufacturing goods,  $\sigma_m$ , should be higher than  $\sigma_s$ , on the reasonable assumption that home-produced manufacturing goods are closer substitutes to the items that can be bought in the market than are home-produced services. The same applies to home food production. Since there are no estimates in the literature for these elasticities we do not venture to guess a number. Instead, for manufacturing we select an elasticity that implies that half of all home manufacturing

activities are marketized in about 15 years.<sup>14</sup> Accordingly, the home manufacturing hours found by Leeds (1917) in his 1912-13 sample would have been reduced to about 20-25 minutes per week by the late 1920s. This elasticity turns out to be  $\sigma_m = 5$ . This appears reasonable to us in light of the estimated overall elasticities discussed in the preceding paragraph.

For the elasticity of substitution  $\varepsilon$  we do not have direct estimates. It is clear from (24) that in a model without home production, and because relative prices are inversely related to relative TFP levels, the own price elasticity of the three goods is  $-\varepsilon$ . It is also clear from (25) that in this case the slope of the regression line between changes in relative employment levels and changes in relative prices should be  $1 - \varepsilon$ . But with home production, and because at least some market-produced services have good substitutes in home-produced services, the estimated price elasticity should be higher than  $-\varepsilon$  in absolute value. Falvey and Gemmell (1996) estimate the price elasticity of the entire service sector and they find it to be  $-0.3$ . They compare their estimate to one by Summers (1985), which is  $-0.06$  and not significantly different from zero. Blundell, Pashardes and Weber (1993) report a “services” price elasticity for Britain of  $-0.7$ . However, they do not give a list of what services are included and since the budget share of their services is only 0.12, it must be a very small list. Their estimate is comparable to the estimates obtained by Falvey and Gemmell (1996) for each of their seven sub-sectors, whose budget shares are on average of the same order of magnitude as the Blundell et al. (1993) sector. In a model with home production, the estimate  $\varepsilon = 0.3$  seems to be an upper bound for the elasticity of substitution, with 0 as lower bound.

With regard to the relation between employment and price changes, we regressed relative employment changes and relative price changes for thirteen 2-digit consumption-goods sectors drawn from the OECD STAN database and input-output tables for 1977-2001, and obtained an average estimate  $1 - \varepsilon = 0.7$ .<sup>15</sup> Given the broader aggregation in this paper, the estimate  $\varepsilon = 0.3$  again emerges as an upper bound for the elasticity. Following these findings, we selected  $\varepsilon = 0.1$  as a good guess for the benchmark elasticity of substitution between our three sectors.

*TFP growth rates.* We use the link between relative prices and TFP levels to derive the differences in TFP growth rates. They are set to match the changes in the prices of agriculture and service goods relative to manufacturing goods. As data for service goods are available only since 1929 we compute mean TFP growth rates for the period since that year. We first compute annual growth rates for each year, then take the average for the entire period. This average is 0.93 per cent for the price ratio of services to manufacturing and  $-1.2$  for the price ratio of agriculture to manufacturing.<sup>16</sup>

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<sup>14</sup>Results are very similar if we select from a range of years, e.g., 10-20.

<sup>15</sup>These results are available in the longer version of Ngai-Pissarides (2004) that circulated as CEPR discussion paper no. 4763 and on our personal web sites.

<sup>16</sup>Source for 1929-1970: *Historical Statistics of the United States: Colonial Times to 1970, Part 1 and 2*. The implicit price deflator for services is in series E17, and the wholesale price index for

We cannot adopt the same methodology to calibrate  $\gamma_{sm} - \gamma_{sh}$  and  $\gamma_{mm} - \gamma_{mh}$ , as there are no estimates on the implicit price of home goods. We set as benchmark zero growth rates in home TFP, although negative TFP growth in the home sector are consistent with our model and with rising labour productivity, because the accumulation of consumer durables could offset it.<sup>17</sup> We reason as follows to get the TFP growth differentials. Given the observed rate of growth of aggregate labour productivity of 2 per cent and a capital share of 1/3, a plausible estimate of manufacturing TFP growth is  $\gamma_{mm} = 1.33$  per cent. So the benchmark value for  $\gamma_{mm} - \gamma_{mh}$  is .0133. If we subtract from  $\gamma_{mm}$  our computed difference between manufacturing and services, 0.0093, we find  $\gamma_{sm} = 0.004$ . Thus,  $\gamma_{sm} - \gamma_{sh} = 0.004$  is the maximum difference consistent with non-negative TFP growth rates for home production. Similarly, the maximum difference for  $\gamma_{am} - \gamma_{ah}$  is 0.0253. These numbers are consistent with the direct estimates of Jorgenson and Gallop (1992), who calculate an average TFP growth rate for the period 1947-85 of 2.06 per cent for agriculture and 0.82 per cent for the private non-farm sector.<sup>18</sup> Within their non-farm sectors, TFP growth rates vary but the TFP growth rates for industrial sectors are in general higher than the ones for service sectors.

*Investment rate.* Finally, the steady-state investment rate is  $\eta = \eta_m / (1 + l_{sh}/q)$ , where  $\eta_m$  is the investment (or saving) as a fraction of market production, which we get from Maddison (1992), and  $l_{sh}$  is the total number of hours in home production for this period. To minimize the role of the Great Depression on the average savings rate, we use the average of 1925-30 as an estimate for 1930, so  $\eta_{m0} = 0.189$ . To compute  $\eta$  we also need the initial home-to-market hour ( $l_{sh0}/q_0$ ). We obtain this ratio from the home and market hours data of Ramey and Francis (2006). To be consistent, we also use the average of 1925-30 as an estimate for 1930, to obtain  $l_{sh0}/q_0 = 0.812$ . Therefore,  $\eta = 0.104$ . The calibrated benchmark values are shown in Table 3.

*Results.* We begin by reporting the results of calibrating the full model since 1930, when home production is entirely of services and the rest of the data are mean values for the entire period - see figure 3. The model tracks the dynamics of employment shares

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industrial commodities and farm products are in series E24-25. For 1970-2000, see *Economic Report of the President*, Tables B-62 and B-67. The measurement of both prices and TFP, especially in the earlier period, is fraught with difficulties, so we use the same TFP differences for the whole period, rather than looking at different sub-periods, even though our balanced growth path allows  $\gamma_{sm}$  and  $\gamma_{am}$  to change over time.

<sup>17</sup>Consider service productivity. The capital-labour ratio in home production is  $k$ , the same as in the market, and so it grows at positive rate  $\gamma_{mm}/(1 - \alpha)$ . “Real” labour productivity in home production is  $A_{sh}k^\alpha$ , which grows at rate  $\alpha\gamma_{mm}/(1 - \alpha) + \gamma_{sh}$ , so a negative  $\gamma_{sh}$  is consistent with positive rate of growth of real labour productivity. Of course, as in the other sectors, the value of average product in the home sector (with manufacturing as numeraire) grows at rate  $\gamma_{mm}$  and the implicit price of home-produced goods rises at rate  $\gamma_{mm} - \gamma_{sh}$ .

<sup>18</sup>The numbers are obtained from adding the productivity growth rates due to input quality adjustment from Table 4 to the TFP growth rates in Table 1, 1.58 for agriculture and 0.44 for the non-farm sector.

Table 3: Baseline Parameters, United States, 1930-2004

$\eta$	$\sigma_s$	$\varepsilon$	$\gamma_{mm}-\gamma_{ma}$	$\gamma_{mm}-\gamma_{sm}$	$\gamma_{am}-\gamma_{ah}$	$\gamma_{mm}-\gamma_{mh}$	$\gamma_{sm}-\gamma_{sh}$
0.104	2.3	0.1	-0.012	0.0093	0.0253*	0.0133*	0.004

\*These numbers are shown here because they are derived from post-1929 data but they are not used in the calibration for the 1930-2004 period. See the text for more details

very well, picking up the fast rise of service employment and the fall in agricultural employment, with smaller changes in manufacturing. In 2000, the employment shares for agriculture, manufacturing and services were 0.02, 0.25 and 0.73 respectively. The model predicts 0.06, 0.29 and 0.65: given the initial distribution of 0.21, 0.36 and 0.43, there is a lot of predictive power in the model. With respect to total market hours, the model generates a very shallow U-shape when compared to the data. Not surprisingly, it does not track the changes in hours in the Great Depression and the war, but it picks up the downward trend up to the mid 1970s and the rise in the last quarter century. In 1930 hours of work per capita were 18.5 per week. In 1961-65, when on this definition hours reached their lowest point, they were on average 16.53 per week. The model predicts a fall to 17.9 hours (with a minimum just below this number reached in the 1970s). By 1995-04, hours of work increased back to 18.7 per week, and the model predicts 18.1 hours per week. As we pointed out, predicting the turning point as part of the same dynamic process that predicts the structural transformation is unique to our model, but it is clear from the results that the productivity explanation is not the only explanation for the observed low-frequency fluctuations in hours of work.

Raising  $\sigma_s$  in these calculations reduces the fall in hours but increases the subsequent rise. More interestingly, given the uncertainty attached to the TFP calculations, we calculated results also for a lower relative manufacturing price. We chose manufacturing because market prices for manufactures may not reflect accurately the improvement in quality. We set the TFP growth differential between agriculture and manufacturing to 0.0053 and the growth differential between manufacturing and services to 0.016 (i.e., we lowered manufacturing relative prices by 0.7 percentage points). The sectoral predictions improve further - the predicted distribution in 2000 now is 0.06, 0.26 and 0.68. With respect to overall hours, the fall in the 1970s is now down to 17.6 hours per week, which is closer to the actual fall, but the rise at the end of the sample is only up to 17.8 hours.

For the period before 1930 we do not have enough data to do a full calibration. For home production we have the interpolations done by Ramey and Francis (2006) for overall hours in home production and the number given by Leeds (1917) for manufacturing-like tasks in 1912-13. As we argued, the published data do not distinguish agricultural home production from unpaid family workers, so we set the home production of agri-



culture in 1900 to zero. For manufacturing we choose an initial value of 10 per cent of all home production. At the elasticity value of  $\sigma_m = 5$  this gives just over 5 per cent in 1912-13, which is consistent with the fraction reported by Leeds. All the other parameters are as in the post-1929 calibration. The results are shown in figure 4. We show results for 1900-1929, as the subsequent period is exactly as in figure 3, conditional on the initial distribution of hours. The main new component in these predictions is the marketization of manufacturing, which moved labour time from the home to the market.

As shown in figure 4, marketization of manufacturing is virtually complete by 1930, which is what we targeted with  $\sigma_m = 5$ . In the data the distribution of the market shares is 0.21, 0.36 and 0.43 respectively for agriculture, manufacturing and services, and we predict 0.23, 0.39 and 0.37, which is close. Our predictions are even closer for the lower relative manufacturing price (respectively, 0.24, 0.37 and 0.39).<sup>19</sup> With respect to total market hours, the model predicts a fall of about 0.5 hours between 1900 and 1929. It is difficult to get an underlying trend for market hours at this time, as the filtered data that we show increase first because of the war (in the unfiltered data hours are flat until the war years) and then fall in anticipation of the Great Depression (the unfiltered data are virtually flat in the 1920s). Given these problems, it might be more appropriate to evaluate the performance of the model by comparing its predictions with the average number of hours before the war and before the Great Depression. The average number of hours in the unfiltered data for 1900-04 is 21.6 and for 1925-09 it is 20.85, giving a fall of 0.75 hours. This compares favourably with the model's predicted 0.5 hour fall.

In the equations underlying figure 4 the decline of manufacturing home production is driven by the product of the elasticity of substitution  $\sigma_m$  and the TFP growth differential between market and home. A higher elasticity gives faster marketization and can offset the structural transformation force completely, to give a small rise in overall market hours. When manufacturing home production is a bigger share of total hours than we calculate it to be at the beginning of the 20th century, this marketization force may explain a rise in hours of work, as some economic historians have claimed for the very early stages of industrialization.

Reasoning along similar lines, had data for agricultural home production been available, the model would have predicted an even faster decline of home-produced agricultural goods, because of the bigger TFP growth differential for agriculture. If we apply the same elasticity of substitution for agriculture,  $\sigma_a = 5$ , which is not unreasonable given how similar home-grown food is to food bought in the market, we would get a half life for agricultural home hours of about 7 to 8 years instead of manufacturing's 15 years.

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<sup>19</sup>For this period we have only four data points for sectoral shares, with a difference of 10 years between adjacent points, which we join up in figure 4.

## 4 More on the economics of leisure

We have treated non-work time so far as in conventional growth and real business cycle models, as leisure time that yields utility directly, without the help of any goods. But a large amount of leisure in time use surveys is enjoyed with the use of some capital or intermediate goods, such as watching TV, surfing the net or talking on the telephone. We generalize our benchmark model by introducing a leisure good  $c_l$  that is produced mostly at home using time and capital goods.<sup>20</sup> One important outcome of this extension is that now changes in leisure time can also cause changes in labour supply, even if the economy is on a balanced growth path.

We assume that leisure is of two types, one as in the benchmark model and one that is the output of a “production” process that uses capital and labour through a production function that is identical to the one for other goods. We use subscript  $l$  for leisure-goods production and let  $A_l$  denote its TFP level. We assume that the leisure good (say TV viewing services) is a better substitute for service goods than it is for agricultural and manufacturing goods. But it is not as good a substitute for market services as home production is. This is the main feature that differentiates home production from leisure production. Home production such as cooked food has market-produced close substitutes but leisure production such as TV viewing does not have close substitutes in the market; if an individual hires somebody to do her TV viewing for her the end product will not be a close substitute to watching the TV herself. Yet both cooked food and TV viewing are produced at home with some durable good purchased from the manufacturing sector.

Formally, we assume that the services aggregate now consists of three goods, market services and home production as before, combined into  $c_s$  as in the benchmark model, and leisure goods, which are combined with  $c_s$  into a grand service good,  $c_S$ . We want the elasticity of substitution between  $c_s$  and  $c_l$  to be bigger than the one between service goods and manufacturing goods (our  $\varepsilon$ ) but smaller than the elasticity of substitution between market and home produced services (our  $\sigma_s$ ). We choose it to be 1, which gives a particularly simple and appealing result on the dynamics of leisure time. But the model also has a solution if the elasticity is bigger or smaller than one.

The utility of goods now is,

$$\phi(\cdot) = \left( \sum \omega_j c_j^{(\varepsilon-1)/\varepsilon} \right)^{\varepsilon/(\varepsilon-1)} \quad j = a, m, S; \quad c_S = c_s^{1-\xi} c_l^\xi, \quad (42)$$

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<sup>20</sup>In time use surveys by far the dominant good of the kind that we have in mind is watching TV. See below in this section for some data. Greenwood and Vandenbroucke (2005) also put forward the idea that the dynamics of leisure time are influenced by the complementarities between durables and time. Their approach, however, is different from ours. They claim that leisure has increased because the quality and variety of goods like TV, which are complementary to leisure time, has gone up. Our claim runs along the lines of our previous discussion, people consume more time watching TV and doing other similar things because technological progress elsewhere has increased their consumption of other goods and other goods are poor substitutes for TV watching time.

with  $c_s$  defined as before, as a CES between  $c_{sm}$  and  $c_{sh}$  with elasticity  $\sigma_s$ . This specification reduces to the benchmark model when  $\xi \rightarrow 0$ . The marketization conditions (15) still hold between the market and home production of service goods. By direct extension a similar condition holds between the service composite  $c_s$  and leisure production  $c_l$  :

$$\frac{l_l}{l_s} = \frac{\xi}{1 - \xi}. \quad (43)$$

This is an important result that is due to our unit elasticity assumption for  $c_s$  and  $c_l$  : the ratio of leisure-production time to service-production time is a constant. The size of the constant depends on the parameter  $\xi$ . It should be obvious and it is straightforward to show that all the other results of the benchmark model still hold, with the composite  $c_S$  replacing  $c_s$ . The composite  $c_S$  now has two “marketization” forces beneath it, the one between market production and home production which holds as before, and the one between leisure and the other two service sectors, given by (43). The aggregates (consumption, income and capital stock) are still defined as before and a balanced growth path with constant capital-output ratio exists. The new element is that on this steady state total leisure is now defined as  $(1 - l) + l_l$ , and it is not constant because of the dynamics of  $l_l$ .

As in the benchmark model and for as long as TFP growth in agriculture and manufacturing exceed TFP growth in the service sectors, service employment is monotonically increasing over time. With  $l_s$  increasing over time, we get from (43) that  $l_l$  is also monotonically increasing over time. Thus, total leisure time,  $1 - l + l_l$ , is increasing over time, with  $l$  constant on the balanced growth path and  $l_l$  rising. We address two questions about this dynamic. First, how big is the share of leisure in time use surveys now and how big is it in the asymptotic state? This will give an idea of the dynamics involved. Second, what happens to overall labour supply when there is leisure production?

The answer to the first question depends mainly on the preference parameter  $\xi$ . This is because both the current and asymptotic  $l_l$  are a constant fraction  $\xi/(1 - \xi)$  of service employment. In the American Time Use Surveys (ATUS) of 2003 and 2004 there is a fairly detailed breakdown of the activities in which people engage in their leisure time. We include under our leisure production TV watching, sports participation and telephone, mail and email and we find that individuals over the age of 15 spend about 21 hours a week in these activities. Total leisure time is about 39 hours and total work time (market and home) 50 hours.<sup>21</sup> Making use of the data on home and market production from the same surveys we get an approximate value of  $\xi = 1/3$ . In the asymptotic steady state our model prediction (on the assumption that the time devoted to the other activities mentioned in the preceding footnote remains the same) is that

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<sup>21</sup>The remainder is spent on essential activities like sleep, 74 hours, education, 3.5 hours and unclassified items, 1.5 hours.

total work converges to 44 hours and total leisure time to 45 hours. So the prediction is that once the structural transformation and marketization forces run their course, there will be a net shift of 6 hours a week from work to leisure activities. It is also predicted that the shift will take a very long time to complete because of the small differentials in the TFP growth rates.

Labour supply with leisure production is  $q = l - l_h - l_l$ . Since home production converges to zero and leisure converges to a constant, labour supply must also converge to a constant. Leisure is rising throughout the adjustment to the asymptotic steady state, whereas we have argued that the structural transformation and marketization forces that drive labour supply in the benchmark first lower labour supply and then increase it. So with leisure production the predicted initial fall in labour supply is faster and due to both the rise in leisure and the rise in home production, whereas in the second phase, when labour supply increases, the rise would be mitigated. Two forces are acting against each other in the second phase, the marketization of home production pushes for a rise in labour supply and the rise in leisure for a fall. With the parameter values used in our benchmark calibrations and  $\xi$  set equal to 1/3, the marketization force dominates and labour supply is on a very slowly increasing trend.<sup>22</sup>

## 5 Conclusions

We have shown that a unified framework can simultaneously account for structural change between agriculture, industry and services and a changing trend in aggregate hours of work without violating balanced aggregate growth. Our prediction of the co-existence of a changing trend in hours on the one hand and balanced aggregate growth on the other is new to a model of economic growth. The assumptions that drive our results are (a) market goods are poor substitutes with each other but home-produced goods have close substitutes in the market, and (b) agriculture and industry have higher rates of total factor productivity growth than do services, but within each sector market production has higher rate of TFP growth than home production. On the aggregate economy's balanced growth path the dynamics of aggregate market hours are driven by the dynamics of home production, but off the steady state there are transitional dynamics with leisure time rising and the supply of labour falling. We have also shown that an extension which refines the use of leisure time and pays attention to the fact that most leisure time is spent with some capital good, such as a TV set, has the implication that leisure time is also rising over time on the balanced growth path.

The qualitative predictions of our model are consistent with the dynamics of hours of work in the United States. Quantitative analysis shows that the model matches well the dynamics of employment shares since 1900 and reasonably well the aggregate

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<sup>22</sup>This conclusion is consistent with the conclusion of Aguiar and Hurst (2005), who find that in recent surveys the fall in home production time has been matched mainly by a rise in leisure time.

dynamics. In particular, we explain a fall in market hours up to the 1970s and a rise since then. The recent rise of female employment is consistent with the marketization of home production emphasized in this paper. Of course, this is not to suggest that no other factor has contributed to the explanation of the dynamics of market hours of work.

We abstracted from international trade and all distortions to competitive market allocations. Distortions can influence the allocation of time between market and home and trade affects manufacturing and services differently, so it is likely to influence structural change. European data show the same general patterns for market hours of work as in the United States, but more recently with some delay in the marketization of home production. We did not discuss in any detail reasons for these differences; taxation, regulation such as restrictions in weekly hours of work and in shop opening times and trade are likely to prove important in accounting for these differences. Future work needs to enrich the technological explanation of trends that we have emphasized in this paper with the introduction of taxes, regulation and international trade, especially if cross-country differences are to be successfully explained (see Freeman and Schettkat, 2005, Prescott, 2004, Rogerson, 2004, and Messina, 2005, for related work).

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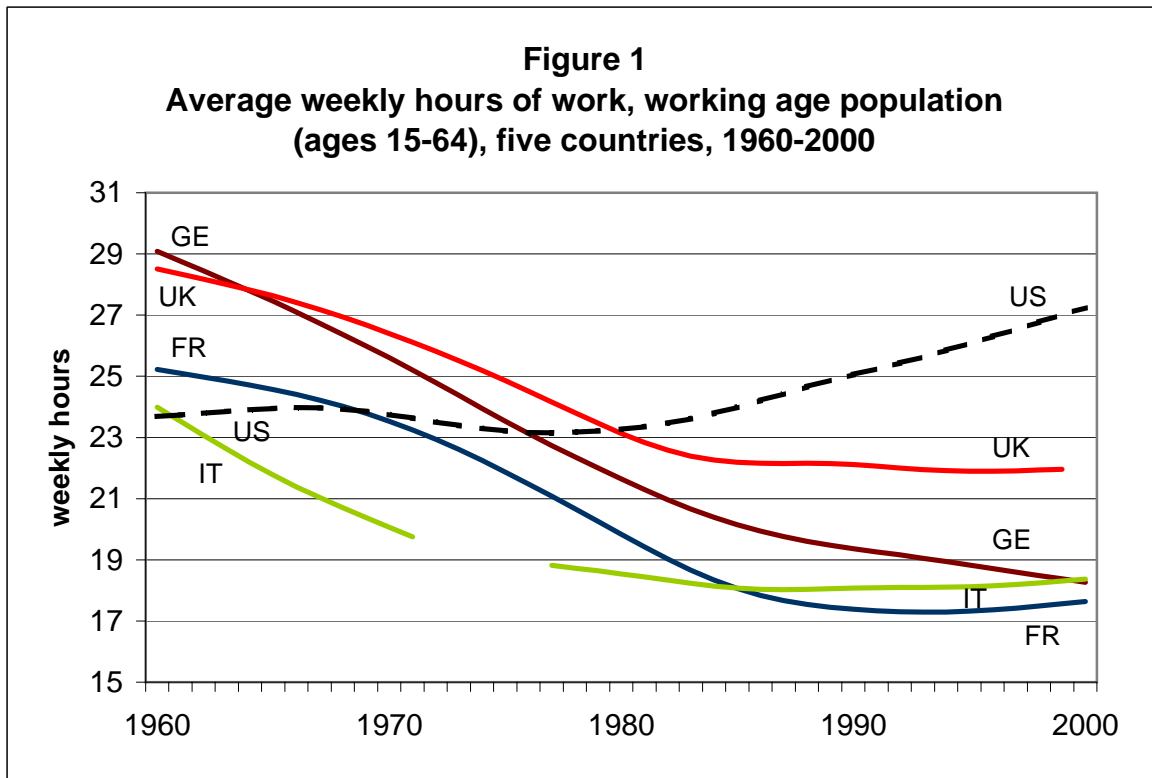
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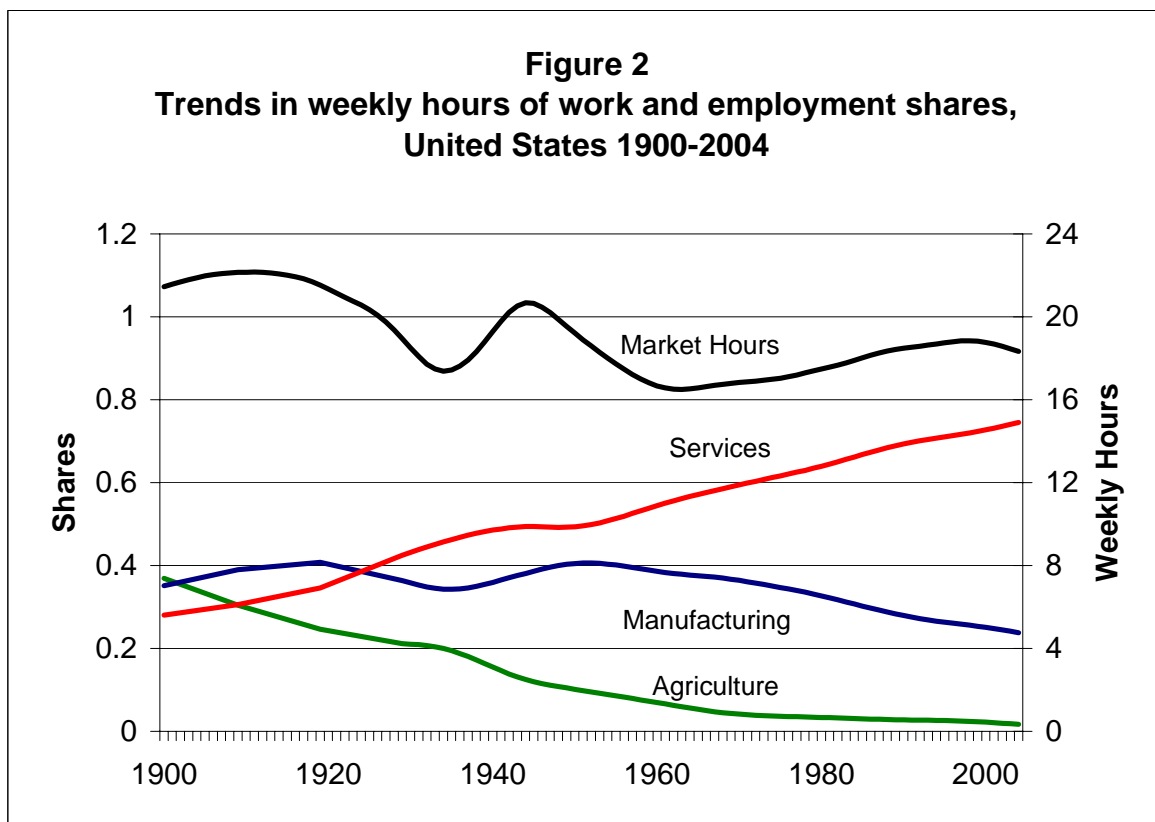
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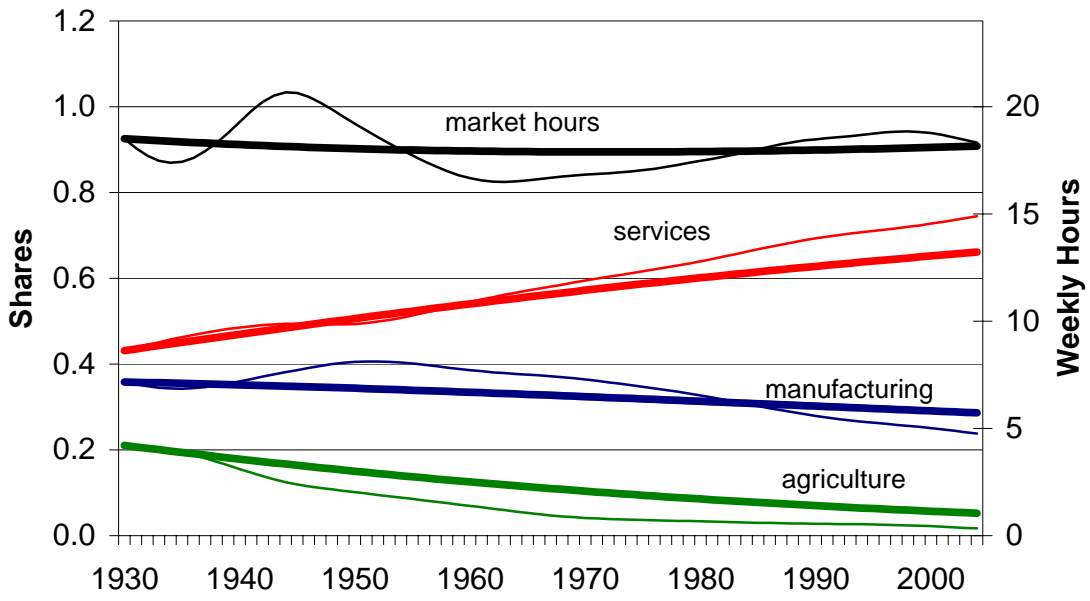
HP filtered data. All filtered data in this and subsequent graphs uses a smoothing parameter of 100.  
 Sources: Total hours, Groningen Growth and Development Centre  
 Working age population, OECD



Definitions: Market Hours is total market hours divided by the population aged 10+ (right scale)  
 Agriculture includes agriculture, forestry and fisheries, industry includes mining, manufacturing, construction, utilities, transportation and communication and services all others (left scale)

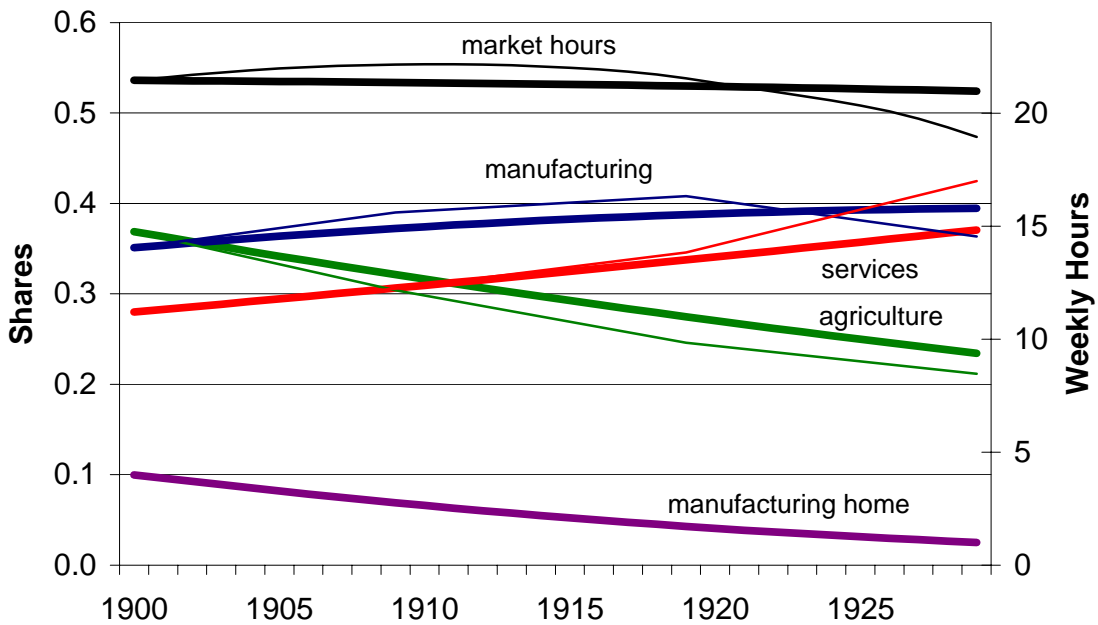
Source: Market Hours, Ramey and Francis (2006), HP filtered  
 Employment shares: Bureau of Economic Analysis for 1929-2004 and Historical Statistics for the United States for 1899, 1909, 1919.  
 The graph is plotted by interpolation between the data points.

**Figure 3**  
**Model predictions, 1930-2004**



model data — (as in figure 2)

**Figure 4**  
**Model predictions, 1900-1929**



model data — (as in figure 2)

"manufacturing home" denotes the fraction of total home production time that produces manufacturing substitutes (left scale)