

# 14.461: Technological Change, Lecture 8

## Technology and the Labor Market

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# Introduction

- Rich dynamics of wages and earnings in many developed country labor markets.
- In fact, going beyond what is generally predicted by models based on two types of skills (as we will see).
- A richer framework combining technology (potentially endogenous) with tasks more useful for thinking about these trends.

## A Two Skill Model

- Suppose that the total supply of low skill labor is  $L$  and the total supply of high skill labor is  $H$ .
- This could be because different “low skill” and “high skill” workers have different skill endowments, for example aggregated as

$$L = \int_{i \in \mathcal{L}} l_i di \text{ and } H = \int_{i \in \mathcal{H}} h_i di.$$

- The key building block is a constant elasticity of substitution aggregate production function similar to what we have seen already.

$$Y = \left[ (A_L L)^{\frac{\sigma-1}{\sigma}} + (A_H H)^{\frac{\sigma-1}{\sigma}} \right]^{\frac{\sigma}{\sigma-1}}, \quad (1)$$

where  $\sigma \in [0, \infty)$  is the elasticity of substitution between high skill and low skill labor, and  $A_L$  and  $A_H$  are factor-augmenting technology terms.

## A Two Skill Model (continued)

- Recall the focal cases are: (i)  $\sigma \rightarrow 0$ , when high skill and low skill workers will be Leontieff, and output can be produced only by using high skill and low skill workers in fixed portions; (ii)  $\sigma \rightarrow \infty$  when high skill and low skill workers are perfect substitutes (and thus there is only one skill, which  $H$  and  $L$  workers possess in different quantities), and (iii)  $\sigma \rightarrow 1$ , when the production function tends to the Cobb-Douglas case.
- Also this framework all technologies are *factor-augmenting*, meaning that technological change serves to either increase the productivity of high or low skill workers (or both).
- This implies that there are no explicitly skill-replacing technologies.

## A Two Skill Model (continued)

- The production function (1) admits three different interpretations.
  - ① There is only one good, and high skill and low skill workers are imperfect substitutes in the production of this good.
  - ② The production function (1) is also equivalent to an economy where consumers have utility function  $\left[ Y_l^{\frac{\sigma-1}{\sigma}} + Y_h^{\frac{\sigma-1}{\sigma}} \right]^{\frac{\sigma}{\sigma-1}}$  defined over two goods. Good  $Y_h$  is produced using only high skill workers, and  $Y_l$  is produced using only low skill workers, with production functions  $Y_h = A_H H$ , and  $Y_l = A_L L$ .
  - ③ A mixture of the above two whereby different sectors produce goods that are imperfect substitutes, and high and low-education workers are employed in both sectors.

## A Two Skill Model (continued)

- Since labor markets are competitive, the low skill unit wage is simply given by the value of marginal product of low skill labor, which is obtained by differentiating (1) as

$$w_L = \frac{\partial Y}{\partial L} = A_L^{\frac{\sigma-1}{\sigma}} \left[ A_L^{\frac{\sigma-1}{\sigma}} + A_H^{\frac{\sigma-1}{\sigma}} (H/L)^{\frac{\sigma-1}{\sigma}} \right]^{\frac{1}{\sigma-1}}. \quad (2)$$

- Given this unit wage, the earnings of worker  $i \in \mathcal{L}$  is simply

$$W_i = w_L l_i.$$

## A Two Skill Model: Implications

- There are two important implications so far:
- ①  $\partial w_L / \partial H / L > 0$ , that is, as the fraction of high skill workers in the labor force increases, the low skill wage should increase. This is an implication of imperfect substitution between high and low skill workers. An increase in the fraction (or relative supply) of high skill workers increases the demand for the services of low skill workers, pushing up their unit wage.
- ②  $\partial w_L / \partial A_L > 0$  and  $\partial w_L / \partial A_H > 0$ , that is, either kind of factor-augmenting technical change *increases* wages of low skill workers (except when  $\sigma = 0$  and  $\sigma = \infty$ , where these inequalities might be weak). This result is intuitive but will also turn out to be important: technological improvements of any sort will lead to higher wages for both skill groups in the canonical model. Thus unless there is “technical regress,” the canonical model cannot account for declining (real) wages of a factor whose supply is not shifting outward.

## A Two Skill Model: Implications (continued)

- Similarly, the high skill unit wage is

$$w_H = \frac{\partial Y}{\partial H} = A_H^{\frac{\sigma-1}{\sigma}} \left[ A_L^{\frac{\sigma-1}{\sigma}} (H/L)^{-\frac{\sigma-1}{\sigma}} + A_H^{\frac{\sigma-1}{\sigma}} \right]^{\frac{1}{\sigma-1}}. \quad (3)$$

- We again have similar comparative statics.
  - First,  $\partial w_H / \partial H / L < 0$ , so that when high skill workers become more abundant, their wages should fall.
  - Second,  $\partial w_H / \partial A_L > 0$  and  $\partial w_H / \partial A_H > 0$ , so that technological progress of any kind increases high skill (as well as low skill) wages.
  - Also similarly, the earnings of worker  $i \in \mathcal{H}$  is simply

$$W_i = w_L h_i.$$

- It can also be verified that an increase in either  $A_L$  or  $A_H$  (and also an increase in  $H/L$ ) will raise average wages in this model



## A Two Skill Model: Wage Inequality

- Combining (2) and (3), the skill premium—the unit high skill wage divided by the unit low skill wage—is

$$\omega = \frac{w_H}{w_L} = \left( \frac{A_H}{A_L} \right)^{\frac{\sigma-1}{\sigma}} \left( \frac{H}{L} \right)^{-\frac{1}{\sigma}}. \quad (4)$$

- Equation (4) can be rewritten in a more convenient form by taking logs,

$$\ln \omega = \frac{\sigma-1}{\sigma} \ln \left( \frac{A_H}{A_L} \right) - \frac{1}{\sigma} \ln \left( \frac{H}{L} \right). \quad (5)$$

- Thus

$$\frac{\partial \ln \omega}{\partial \ln H/L} = -\frac{1}{\sigma} < 0. \quad (6)$$

- Related to Tinbergen's race between supply of skills and technology: for a *given skill bias of technology*, captured here by  $A_H/A_L$ , an increase in the relative supply of skills  $H/L$  reduces the skill premium with an elasticity of  $1/\sigma$ —via two different types of substitution.

## Wage Inequality (continued)

- Also, as we have already observed:

$$\frac{\partial \ln \omega}{\partial \ln(A_H/A_L)} = \frac{\sigma - 1}{\sigma}. \quad (7)$$

- If  $\sigma > 1$ , then relative improvements in the high skill-augmenting technology (i.e., in  $A_H/A_L$ ) increase the skill premium—i.e., a shift out of the relative demand curve for skills.
- The converse is obtained when  $\sigma < 1$ : that is, when  $\sigma < 1$ , an improvement in the productivity of high skill workers,  $A_H$ , relative to the productivity of low skill workers,  $A_L$ , shifts the relative demand curve inward and reduces the skill premium.

## Bringing Tinbergen's Race to the Data

- To operationalize Tinbergen's hypothesis, suppose the following smooth behavior of skill bias over time

$$\ln \left( \frac{A_{H,t}}{A_{L,t}} \right) = \gamma_0 + \gamma_1 t, \quad (8)$$

where  $t$  is calendar time and variables written with  $t$  subscript refer to these variables at time  $t$ .

- Then:

$$\ln \omega_t = \frac{\sigma - 1}{\sigma} \gamma_0 + \frac{\sigma - 1}{\sigma} \gamma_1 t - \frac{1}{\sigma} \ln \left( \frac{H_t}{L_t} \right). \quad (9)$$

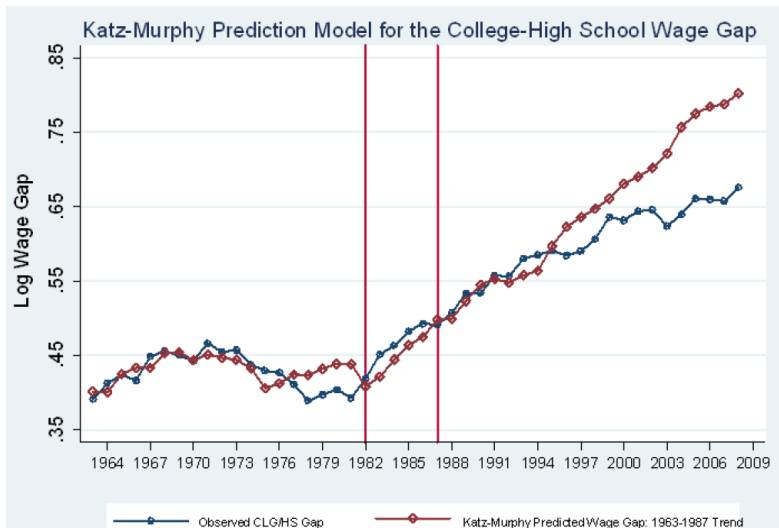
- Estimating this for 1963–1987, following Katz and Murphy (1992), we obtain

$$\ln \omega_t = \text{constant} + 0.027 \times t - 0.612 \cdot \ln \left( \frac{H_t}{L_t} \right)$$

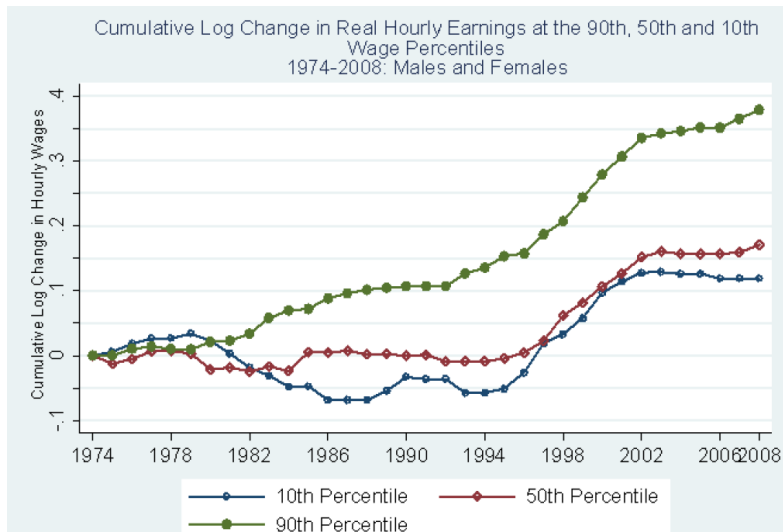
(0.005)                      (0.128)

- However, the fit of the model deteriorates for longer samples.

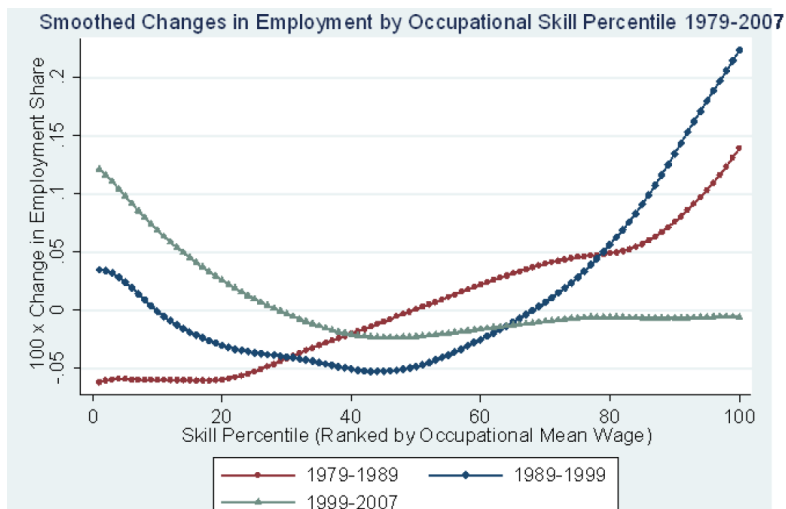
# Model Fit



# Beyond Two Skills



# Beyond Two Skills (continued)



# Environment

- We consider a static environment with a unique final good.
- For now, the economy is closed and there is no trade in tasks (a possibility we allow for later).
- The unique final good is produced by combining a continuum of tasks represented by the unit interval,  $[0, 1]$ .
- Let us simplify the analysis assuming a Cobb-Douglas technology mapping the services of this range of tasks to the final good:

$$Y = \exp \left[ \int_0^1 \ln y(i) di \right]. \quad (10)$$

- Throughout, we choose the price of the final good as the numeraire.

# Skills and Tasks

- There are three factors of production, high, medium and low skilled workers. In addition, we will introduce capital or technology (embedded in machines) below.
- Suppose, for now, that there is a fixed, inelastic supply of the three types of workers,  $L$ ,  $M$  and  $H$ .
- Skills and tasks are not the same thing. Workers have endowments of skills and use these endowments in order to perform tasks, which are units of activities that are part of the production process.



# Tasks

- Each task has the following production function

$$y(i) = A_L \alpha_L(i) l(i) + A_M \alpha_M(i) m(i) + A_H \alpha_H(i) h(i) + A_K \alpha_K(i) k(i), \quad (11)$$

where  $A$  terms represent factor-augmenting technology, and  $\alpha_L(i)$ ,  $\alpha_M(i)$  and  $\alpha_H(i)$  are the task productivity schedules, designating the productivity of low, medium and high skill workers in different tasks.

- For example,  $\alpha_L(i)$  is the productivity of low skill workers in task  $i$ , and  $l(i)$  is the number of low skill workers allocated to task  $i$ .
- We will make a *comparative advantage* assumption, ensuring that high skill workers are relatively better at high, more complex tasks:

**Assumption 1**  $\alpha_L(i) / \alpha_M(i)$  and  $\alpha_M(i) / \alpha_H(i)$  are continuously differentiable and strictly decreasing.

# Market Clearing

- Factor market clearing requires

$$\int_0^1 l(i) di \leq L, \int_0^1 m(i) di \leq M \text{ and } \int_0^1 h(i) di \leq H. \quad (12)$$

- When we introduce capital, we will assume that it is available at some constant price  $r$ .

## Allocation of Skills to Tasks

- In view of the structure of comparative advantage differences in Assumption 1, there will exist some  $l_L$  and  $l_H$  such that all tasks  $i < l_L$  will be performed by low skill workers, and all tasks  $i > l_H$  will be performed by high skill workers. Intermediate tasks will be performed by medium skilled workers.
- We can think of these intermediate tasks as the routine tasks performed by workers in many production, clerical, and administrative support occupations.
- More formally, we have:

### Lemma

*In any equilibrium there exist  $l_L$  and  $l_H$  such that  $0 < l_L < l_H < 1$  and for any  $i < l_L$ ,  $m(i) = h(i) = 0$ , for any  $i \in (l_L, l_H)$ ,  $l(i) = h(i) = 0$ , and for any  $i > l_H$ ,  $l(i) = m(i) = 0$ .*

## The Law of One Wage (Price)

- Even though workers of the same skill level perform different tasks, in equilibrium they will receive the same wage—a simple “law of one price” that has to hold in any competitive equilibrium,
- Let  $p(i)$  denotes the price of services of task  $i$ . Since we chose the final good as numeraire (setting its price to 1), we have

$$\exp \left[ \int_0^1 \ln p(i) di \right] = 1.$$

- Since all tasks employing low skill workers must pay them the same wage,  $w_L$ , we have

$$w_L = p(i)A_L\alpha_L(i) \text{ for any } i < I_L.$$

- And similarly, for other skill groups:

$$w_M = p(i)A_M\alpha_M(i) \text{ for any } I_L < i < I_H.$$

$$w_H = p(i)A_H\alpha_H(i) \text{ for any } i > I_H.$$

# Prices

- This observation also determines prices as the price difference between any two tasks produced by the same type of worker must exactly offset the productivity difference of this type of worker in these two tasks. For example:

$$p(i)\alpha_L(i) = p(i')\alpha_L(i') \equiv P_L, \quad (13)$$

for any  $i, i' < I_L$ , where the last equality defines  $P_L$  as the price “index” of tasks performed by low skill workers.

- Similarly, for medium skill workers, i.e., for any  $I_H > i, i' > I_L$ , we have

$$p(i)\alpha_M(i) = p(i')\alpha_M(i') \equiv P_M, \quad (14)$$

and for high skill workers and any  $i, i' > I_H$ ,

$$p(i)\alpha_H(i) = p(i')\alpha_H(i') \equiv P_H. \quad (15)$$

## Prices (continued)

- The Cobb-Douglas technology (the unitary elasticity of substitution between tasks) in (10) implies that “expenditure” across all tasks should be equalized, and given our choice of numeraire, this expenditure should be equal to the value of total output.
- More specifically, the first-order conditions for cost minimization in the production of the final good imply that  $p(i)y(i) = p(i')y(i')$  for any  $i, i'$ , or

$$p(i)y(i) = Y, \text{ for any } i \in [0, 1]. \quad (16)$$

## Labor Allocation

- Now consider two tasks  $i, i' < l_L$  (performed by low skill workers), then using the definition of the productivity of low skill workers in these tasks, we have

$$p(i)\alpha_L(i)l(i) = p(i')\alpha_L(i')l(i').$$

- Therefore, for any  $i, i' < l_L$ , we have  $l(i) = l(i')$ , and from labor market clearing,

$$l(i) = \frac{L}{l_L} \text{ for any } i < l_L. \quad (17)$$

- Similarly for other skill groups

$$m(i) = \frac{M}{l_H - l_L} \text{ for any } l_H > i > l_L. \quad (18)$$

$$h(i) = \frac{H}{1 - l_H} \text{ for any } i > l_H. \quad (19)$$

## Relative Prices

- Now comparing tasks performed by high and medium skill workers ( $I_L < i < I_H < i'$ ), we also think

$$\frac{P_M A_M M}{I_H - I_L} = \frac{P_H A_H H}{1 - I_H},$$

or

$$\frac{P_H}{P_M} = \left( \frac{A_H H}{1 - I_H} \right)^{-1} \left( \frac{A_M M}{I_H - I_L} \right). \quad (20)$$

- Similarly, comparing two tasks performed by medium and high skill workers, we obtain

$$\frac{P_M}{P_L} = \left( \frac{A_M M}{I_H - I_L} \right)^{-1} \left( \frac{A_L L}{I_L} \right). \quad (21)$$



## No Arbitrage

- Now the threshold tasks must be determined such that there is no possible “arbitrage” from having a task produced by different type of worker.
- to ensure this, in view of Assumption 1, it is sufficient to check bordering tasks.
- Thus no arbitrage condition between high and medium skills implies

$$\frac{A_M \alpha_M (I_H) M}{I_H - I_L} = \frac{A_H \alpha_H (I_H) H}{1 - I_H}, \quad (22)$$

- and no arbitrage between medium and low skills gives

$$\frac{A_L \alpha_L (I_L) L}{I_L} = \frac{A_M \alpha_M (I_L) M}{I_H - I_L}. \quad (23)$$

# Equilibrium Wages

- Once the threshold tasks,  $I_L$  and  $I_H$ , are determined, wage levels and earnings differences across skill groups can be found in a straightforward manner.
- For example, for low skill workers,

$$w_L = P_L A_L. \quad (24)$$

## Wage Inequality

- Wage inequality and skill premia are also straightforward.
- Comparing high and medium skill wages, we have

$$\frac{w_H}{w_M} = \frac{P_H A_H}{P_M A_M}.$$

- Substituting out relative prices, this gives

$$\frac{w_H}{w_M} = \left( \frac{1 - I_H}{I_H - I_L} \right) \left( \frac{H}{M} \right)^{-1}. \quad (25)$$

- Similarly, the wage of medium relative to low skill workers is given by

$$\frac{w_M}{w_L} = \left( \frac{I_H - I_L}{I_L} \right) \left( \frac{M}{L} \right)^{-1}. \quad (26)$$

- These expressions highlight the central role that allocation of tasks to skills plays in the model. Relative wages can be expressed simply as a function of relative supplies and equilibrium task assignments (in particular, the threshold tasks,  $I_L$  and  $I_H$ ).

# Prices

- Finally, using the choice of the numeraire,  $\int_0^1 \ln p(i) di = 0$ , together with (13)-(15), we also have

$$\int_0^{l_L} (\ln P_L - \ln \alpha_L(i)) di + \int_{l_L}^{l_H} (\ln P_M - \ln \alpha_M(i)) di + \int_{l_H}^1 (\ln P_H - \ln \alpha_H(i)) di = 0 \quad (27)$$

- Equations (25) and (26) give the relative wages of high to medium and medium to low skill workers.
- To obtain the wage *level* for any one of these three groups, we need to use the price normalization in (27) together with (20) and (21) to solve out for one of the price indices, for example,  $P_L$ , and then (24) will give  $w_L$  and the levels of  $w_M$  and  $w_H$  can be readily obtained from (25) and (26).

# Summary of Equilibrium

## Proposition

*There exists a unique equilibrium summarized by  $(I_L, I_H, P_L, P_M, P_H, w_L, w_M, w_H)$  given by equations (20), (21), (22), (23), (24), (25), (26) and (27).*

- Uniqueness follows from Assumption 1.

## Diagrammatic Representation

- To do this, we can rewrite (22) as follows:

$$\frac{1 - I_H \alpha_M(I_H)}{I_H - I_L \alpha_H(I_H)} = \frac{A_H H}{A_M M}. \quad (28)$$

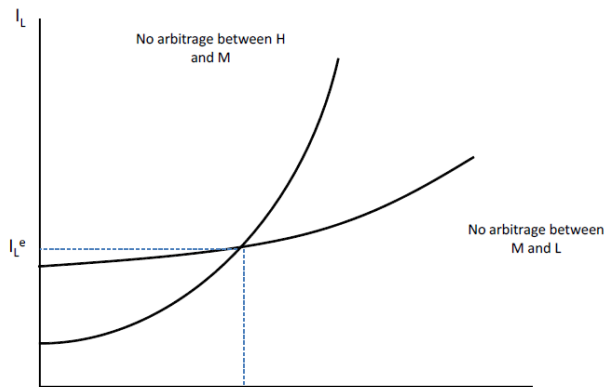
- The right-hand side of this equation corresponds to the relative effective supply of high to medium skills.
- The left-hand side, on the other hand, can be interpreted as the effective demand for high relative to medium skills.
- Similarly, we rewrite (23) as:

$$\frac{I_H - I_L \alpha_L(I_H)}{I_L \alpha_M(I_H)} = \frac{A_M M}{A_L L}$$

for given  $I_H$ , and this expression has the same relative effective demand and supply interpretation.

## Figure

Determination of Equilibrium Threshold Tasks



## Special Cases

- If there are no medium skill workers, then Assumption 1 simply implies that  $\alpha_L(i) / \alpha_H(i)$  is strictly decreasing in  $i$  and we are back to a version of the two-factor standard framework.
- One example is Acemoglu and Zilibotti (2001), who also assume the following form of comparative advantage:

$$\alpha_L(i) = 1 - i \text{ and } \alpha_H(i) = i. \quad (29)$$

- This then gives the threshold task  $l$  as

$$\frac{1 - l}{l} = \left( \frac{A_H H}{A_L L} \right)^{1/2}.$$



## Special Cases (continued)

- We can then obtain the following:
- Relative prices:

$$\frac{P_H}{P_L} = \left( \frac{A_H H}{A_L L} \right)^{-1/2} .$$

- And relative wages:

$$\frac{w_H}{w_L} = \left( \frac{A_H}{A_L} \right)^{1/2} \left( \frac{H}{L} \right)^{-1/2} .$$

- Thus the model is isomorphic to the standard framework with less is the of substitution equal to 2.

## Comparative Statics

- To derive these comparative statics, we return to the general model, and take logs in equations (22) and (23) to obtain slightly simpler expressions, given by the following two equations:

$$\ln A_M - \ln A_H + \beta_H(I_H) + \ln M - \ln H - \ln(I_H - I_L) + \ln(1 - I_H) = 0, \quad (30)$$

and

$$\ln A_L - \ln A_M + \beta_L(I_L) + \ln L - \ln M + \ln(I_H - I_L) - \ln(I_L) = 0, \quad (31)$$

where we have defined

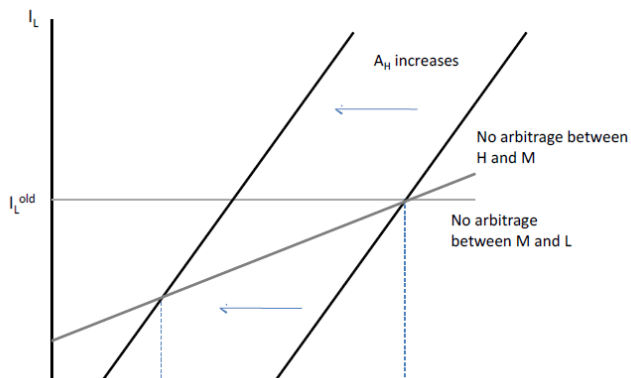
$$\beta_H(I) \equiv \ln \alpha_M(I) - \ln \alpha_H(I) \quad \text{and} \quad \beta_L(I) \equiv \ln \alpha_L(I) - \ln \alpha_M(I),$$

both of which are strictly decreasing in view of Assumption 1.

# Comparative Statics: An Increase in $A_H$

 $A_H$ 

Comparative Statics



# Comparative Statics: Summary

## Proposition

*(The response of task allocation to technology and skill supplies):*

$$\begin{aligned} \frac{dI_H}{d \ln A_H} &= \frac{dI_H}{d \ln H} < 0, \quad \frac{dI_L}{d \ln A_H} = \frac{dI_L}{d \ln H} < 0 \quad \text{and} \quad \frac{d(I_H - I_L)}{d \ln A_H} = \frac{d(I_H - I_L)}{d \ln H} < 0; \\ \frac{dI_H}{d \ln A_L} &= \frac{dI_H}{d \ln L} > 0, \quad \frac{dI_L}{d \ln A_L} = \frac{dI_L}{d \ln L} > 0 \quad \text{and} \quad \frac{d(I_H - I_L)}{d \ln A_L} = \frac{d(I_H - I_L)}{d \ln L} < 0; \\ \frac{dI_H}{d \ln A_M} &= \frac{dI_H}{d \ln M} > 0, \quad \frac{dI_L}{d \ln A_M} = \frac{dI_L}{d \ln M} < 0 \quad \text{and} \quad \frac{d(I_H - I_L)}{d \ln A_M} = \frac{d(I_H - I_L)}{d \ln M} > 0. \end{aligned}$$

# Comparative Statics: Summary (continued)

## Proposition

(The response of relative wages to skill supplies):

$$\begin{aligned} \frac{d \ln (w_H / w_L)}{d \ln H} &< 0, \quad \frac{d \ln (w_H / w_M)}{d \ln H} < 0, \quad \frac{d \ln (w_H / w_L)}{d \ln L} > 0, \\ \frac{d \ln (w_M / w_L)}{d \ln L} &> 0, \quad \frac{d \ln (w_H / w_M)}{d \ln M} > 0, \quad \text{and} \\ \frac{d \ln (w_H / w_L)}{d \ln M} &\begin{cases} \leq \\ \geq \end{cases} 0 \text{ if and only if } |\beta'_L(I_L) I_L| \begin{cases} \geq \\ \leq \end{cases} |\beta'_H(I_H) (1 - I_H)|. \end{aligned}$$

# Comparative Statics: Summary (continued)

## Proposition

*(The response of wages to factor-augmenting technologies):*

$$\frac{d \ln (w_H / w_L)}{d \ln A_H} > 0, \quad \frac{d \ln (w_M / w_L)}{d \ln A_H} < 0, \quad \frac{d \ln (w_H / w_M)}{d \ln A_H} > 0;$$

$$\frac{d \ln (w_H / w_L)}{d \ln A_L} < 0, \quad \frac{d \ln (w_M / w_L)}{d \ln A_L} < 0, \quad \frac{d \ln (w_H / w_M)}{d \ln A_L} > 0;$$

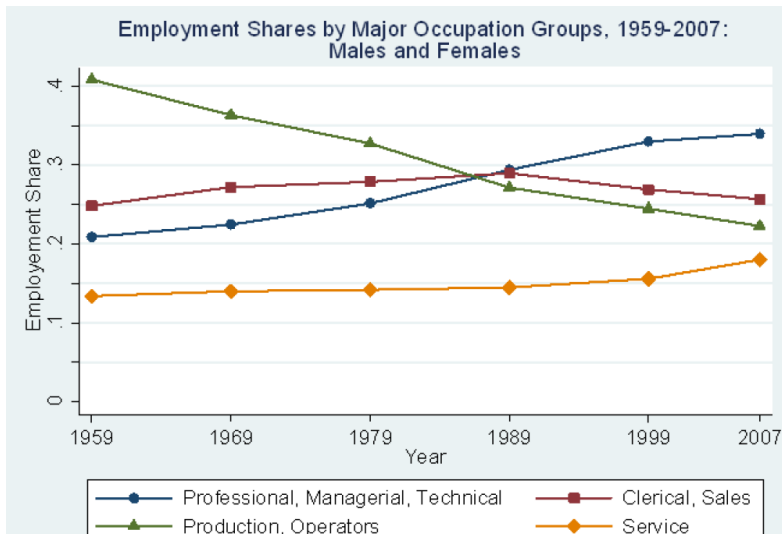
$$\frac{d \ln (w_H / w_M)}{d \ln A_M} < 0, \quad \frac{d \ln (w_M / w_L)}{d \ln A_M} > 0, \quad \text{and}$$

$$\frac{d \ln (w_H / w_L)}{d \ln A_M} \begin{matrix} \leq \\ \geq \end{matrix} 0 \text{ if and only if } |\beta'_L (I_L) I_L| \begin{matrix} \geq \\ \leq \end{matrix} |\beta'_H (I_H) (1 - I_H)|.$$

## Machines Replacing Labor

- We can now investigate indications of new technologies/machines directly displacing workers from tasks that they previously performed.
- Autor, Levy and Murnane (2003): this should be thought of as machines replacing workers performing “routine tasks”, closer related to tasks performed by medium skill (semi-skilled) workers.
- For this reason, let us suppose that there now exists a range of tasks  $[I', I''] \subset [I_L, I_H]$  for which  $\alpha_K(i)$  increases sufficiently (with fixed cost of capital  $r$ ) so that are now more economically preformed by machines than middle skill workers.
- For all the remaining tasks, i.e., for all  $i \notin [I', I'']$ , we continue to assume that  $\alpha_K(i) = 0$ .

# Suggestive Evidence





## Machines Replacing Labor (continued)

### Proposition

*Suppose we start with an equilibrium characterized by thresholds  $[l_L, l_H]$  and technical change implies that the tasks in the range  $[l', l''] \subset [l_L, l_H]$  are now performed by machines. Then after the introduction of machines, there exists new unique equilibrium characterized by new thresholds  $\hat{l}_L$  and  $\hat{l}_H$  such that  $0 < \hat{l}_L < l' < l'' < \hat{l}_H < 1$  and for any  $i < \hat{l}_L$ ,  $m(i) = h(i) = 0$  and  $l(i) = L/\hat{l}_L$ ; for any  $i \in (\hat{l}_L, l') \cup (l'', \hat{l}_H)$ ,  $l(i) = h(i) = 0$  and  $m(i) = M/(\hat{l}_H - l'' + l' - \hat{l}_L)$ ; for any  $i \in (l', l'')$ ,  $l(i) = m(i) = h(i) = 0$ ; and for any  $i > \hat{l}_H$ ,  $l(i) = m(i) = 0$  and  $h(i) = H/(1 - \hat{l}_H)$ .*

- Implication: reallocation of tasks in the economy as medium skill workers will now start performing some of the tasks previously allocated to low skill workers, thus increasing the supply of these tasks

# Machines Replacing Labor: Wage Inequality

## Proposition

Suppose we start with an equilibrium characterized by thresholds  $[I_L, I_H]$  and technical change implies that the tasks in the range  $[I', I''] \subset [I_L, I_H]$  are now performed by machines. Then:

- ①  $w_H / w_M$  increases;
- ②  $w_M / w_L$  decreases;
- ③  $w_H / w_L$  increases if  $|\beta'_L(I_L) I_L| < |\beta'_H(I_H) (1 - I_H)|$  and  $w_H / w_L$  decreases if  $|\beta'_L(I_L) I_L| > |\beta'_H(I_H) (1 - I_H)|$ .

## Machines Replacing Labor: Wage Inequality (continued)

- Intuition for the first two parts is straightforward.
- The impact of this type of technical change on the wage of high skill relative to low skill workers is also naturally ambiguous.
- The condition  $|\beta'_L(I_L) I_L| < |\beta'_H(I_H) (1 - I_H)|$  is also intuitive as it implies that medium skill workers are closer substitutes for low than high skill workers in the sense that, around  $I_H$ , there is a stronger comparative advantage of high skill relative to medium skill workers than there is comparative advantage of low relative to medium skill workers around  $I_L$ .

## Machines Replacing Labor: Special Case

- Suppose

$$\alpha_H(i) = \begin{cases} \theta^{\tilde{I}_H - i} \tilde{\alpha}_H(i) & \text{if } i \leq \tilde{I}_H \\ \tilde{\alpha}_H(i) & \text{if } i > \tilde{I}_H \end{cases} \quad (32)$$

where  $\tilde{\alpha}_H(i)$  is a function that satisfies Assumption 1 and  $\theta \geq 1$ , and suppose that  $\tilde{I}_H$  is in the neighborhood of the equilibrium threshold task for high skill workers,  $I_H$ .

- The presence of the term  $\theta^{\tilde{I}_H - i}$  in (32) implies that an increase in  $\theta$  creates an upward twist in the task productivity schedule for high skill workers around  $\tilde{I}_H$ .

## Machines Replacing Labor: Special Case (continued)

- Consider the implications of an increase in  $\theta$ . High skill workers can now successfully perform tasks previously performed by medium skill workers, and hence will replace them in tasks close to  $\tilde{l}_H$  (or close to the equilibrium threshold  $l_H$ ).
- Therefore, even absent machine-substitution for medium skill tasks, the model generates comparative static results similar to those discussed above, highlighting the parallel roles that technology (embodied in machinery) and task productivity schedules (represented by  $\alpha(\cdot)$ ) play.