

General Purpose Technology, Growth, and Dynamic Gains from Trade

Wen-Tai Hsu Raymond G. Riezman Ping Wang Han Yang^{*†}

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Abstract

This paper develops a dynamic general-equilibrium model of trade, innovation, and growth rooted in the evolution of general purpose technology that is applied to all differentiated products. While innovation in general purpose technology originates only in the North, this technology can enhance the invention and production of differentiated products in both the North and the South. We find that trade liberalization induces more R&D on general purpose technology and hence faster long-run growth, with the North-South trade and innovation structure playing a key role in this process. The model is generalized and calibrated for multi-country quantitative analyses, in which we find large total gains from trade, with the dynamic component dominating the conventional static and income-gains components. Such dominance is stronger when the initial trade costs are higher.

^{*}Hsu: Institute of Economics, Academia Sinica. E-mail: wthsu@econ.sinica.edu.tw. Riezman: Aarhus University, University of California, Santa Barbara, University of Iowa. Email: raymond-riezman@uiowa.edu. Wang: Department of Economics, Washington University in St. Louis, NBER. E-mail: pingwang@wustl.edu. Yang: Institute of Economics, Academia Sinica. E-mail: han.yang271@gmail.com.

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The essence of technological modernity is non-stationarity: ... as far as future technological progress and economic growth are concerned, not even the sky is the limit. ... Inside the black box of technology is a smaller black box called “research and development” which translates inputs into the output of knowledge. This black box itself contains an even smaller black box which models the available knowledge in society ... (Mokyr, 2005).

1 Introduction

What sets the post-industrial-revolution world economy apart from earlier eras is the sustained growth that sees no limits. As Mokyr (1992) argues, macroinvention and Schumpeterian growth—as opposed to microinvention and Smithian growth—are the primary drivers of the modern industrial world. Historical examples of macroinventions include the printing press, steam engines, internal combustion engines, electricity, and, most recently, information technology (in particular, computers, semiconductors, and artificial intelligence). Just how do macroinventions influence long-run growth, and how can they, through plausible underlying mechanisms, drive long-run gains from trade? Moreover, how large are these growth-driven gains compared to conventional static gains? To address these open questions, we will develop a North-South trade model of Schumpeterian growth that enables a thorough quantitative analysis of the size and the underlying sources of long-run gains from trade.

We focus on a realistic scenario in which a macroinvention is periodically improved (as seen in the industries mentioned above), thereby amplifying its permeating effects. In other words, we study how the incentives to improve a *general purpose technology* (hereafter, GPT) are affected by markets and trade, and the resulting welfare implications. A GPT is defined by the following three features (Bresnahan and Trajtenberg, 1995; Jovanovic and Rousseau, 2005): (i) **productivity improvement** – GPT should get better over time and hence keep lowering the costs of its users; (ii) **pervasiveness** – GPT should be applied broadly to many sectors and products; (iii) **innovation spawning** – GPT should make it easier to invent and produce new products or to the production processes. Jovanovic and Rousseau (2005) provides empirical evidence for these features in the cases of electrification and information technology.¹ In addition, they show that both cases were accompanied by a rise in *creative destruction* and turbulence as measured by the entry and exit of firms, as well as by mergers and takeovers. Moreover, because GPT innovations

¹For other earlier theoretical and empirical work on GPT, see Mokyr (1992), Helpman and Trajtenberg (1994), Aghion, Howitt and Violante (2002), and Crafts (2004).

tend to be geographically concentrated, we consider a North-South trade structure in which GPT is innovated in the North. As argued by Mokyr (1992), innovation in the GPT is generally more difficult than other innovations and requires a high-quality institutional environment. Empirical studies have also shown that the spatial distribution of innovation (let alone the GPT innovation) is highly uneven, with the North countries having a dominant share (e.g., see Egger and Loumeau 2018).

We model the evolution of GPT technology using the endogenous growth framework *a la* Aghion and Howitt (1992) (henceforth, AH) in which the sustained growth of the economy is driven by R&D with creative destruction. In particular, the advancement of the GPT is modeled as a “productivity ladder” to capture the productivity improvement feature. We extend this productivity-ladder model to a general-equilibrium trade setting of Bernard et al. (2003) (henceforth, BEJK). Each entrepreneur in our economy enters a market for a specific product and develops an idea (a blueprint) for how this product may be produced. The productivities of their blueprints are ex post heterogeneous, and entrepreneurs compete globally in a Bertrand fashion as in BEJK. The GPT can benefit all differentiated products, which captures the pervasiveness feature. Whenever the GPT advances, the blueprints for producing differentiated products must be redrawn. Furthermore, an improved GPT enables the generation of more ideas (idea creation), capturing the core feature of spawning innovation. As there is only one winner in the Bertrand competition among entrepreneurs for the same product, the idea redraws imply that the incumbents may be replaced by other entrepreneurs, causing creative destruction as documented by Jovanovic and Rousseau (2005). To be consistent with actual observations, we assume that GPT innovation is conducted only in a subset of countries, the North, but the GPT is used by all differentiated-product firms in both the North and the South countries.

Our analysis proceeds in three steps. First, we lay out the model with only two countries (the North and the South). This simple structure allows us to analyze the essential forces at work. Second, we extend the model to allow for an arbitrary number of countries and a flexible structure of bilateral trade costs to prepare for the quantitative analysis. We focus on studying the properties related to welfare gains from trade in the quantitative model. Finally, we calibrate the model and conduct a set of counterfactual analyses to gauge the size of the total gains from trade and how much the GPT innovation and dynamic interaction between trade and innovation matter.

In the two-country model, we show that the link between GPT innovation and trade costs is captured by an **R&D multiplier** that is the ratio of aggregate world revenue of differentiated products to the North’s wages. Trade liberalization induces this multiplier

to increase, hence incentivizing GPT innovation and increasing the economic growth rate. The intuition is that aggregate world revenue reflects the marginal benefit of GPT innovation, whereas the labor costs in the North reflect the marginal cost. A more integrated economy reduces the wage gap between the North and the South and increases the global market size of differentiated products in terms of the North's labor. Thus, R&D effort increases, as does the growth rate of the economy. This mechanism is a novel virtuous cycle between trade and innovation that amplifies dynamic gains from trade.²

Next, we extend the model to allow for any number of countries and a flexible structure of bilateral trade costs for quantitative purposes. We then show that the long-run welfare change in response to a change in trade cost can be decomposed into a growth-rate effect (GR), an income-gains effect (IG), and the ACR statistic ([Arkolakis, Costinot and Rodríguez-Clare, 2012](#)). Here, the GR effect is a direct dynamic effect of a trade shock, as it reflects how growth amplifies the gains from trade. The IG comes from the payments the North receives from the differentiated-product firms worldwide for using the GPT. ACR gains come from the usual static sources as in the ACR setting. However, as the general equilibrium effects (on wages and goods prices) are intertwined among the three channels, the generalized model also allow us to further perform counterfactual analysis to identify the *true dynamic gains*.

The generalized model is calibrated to the world economy during 2000-2014. We quantitatively analyze two scenarios of trade liberalization: (i) the first is a common exercise studying trade liberalization from autarky to the benchmark trade costs, and (ii) the second examines the effects of a moderate 25% reduction in trade costs from observed current states. For the first scenario, the population-weighted average of total gains is 30.6% (with the North gaining slightly more than the South), where the dynamic share is almost 90% (with this share being slightly lower for northern countries because they have higher ACR gains and income gains on average). This large welfare gain figure is about twice as much as existing dynamic models with technology spillovers (e.g., [Perla, Tonetti and Waugh \(2021\)](#)), process innovation (e.g., [Bloom et al. \(2020\)](#)) and product-ladder vertical innovation (e.g., [Hsieh, Klenow and Nath \(2023\)](#)), respectively, serving as the main driver of endogenous growth (their figures range from 12% to 17%). This is mainly due to our consideration of the three fundamental features of the GPT integrating vertical and horizontal innovation and idea creation in such a way that they interact with each other to support a dominant role of the Schumpeterian growth channel.

²This mechanism of trade and growth, with globalization characterized by falling tariffs and improving transport technology contributing to the narrowing of income and wage gaps between developed and developing countries, is consistent with recent research (see, e.g., [Caliendo et al. 2015](#)).

In the second scenario, a 25% reduction in estimated trade costs, the weighted average of the total gains and growth-rate gains are 3.7% and 0.11%, respectively. Not only the total gains are much smaller than in the first scenario because of much smaller changes in trade costs, the decomposition analysis reveals a drastically reduced dynamic share to merely 3.0%. To understand this intriguing finding, we observe that as the world becomes more integrated, the North-South wage gap is narrowing, which tends to increase the global market size of differentiated products (in units of the North's labor) and hence the R&D multiplier. Thus, drastically reducing the initially high trade cost in the first scenario generates a much larger reduction in the wage gap, thereby resulting in a novel **virtuous cycle** between trade and innovation that amplifies dynamic gains from trade.

The main takeaways from our paper are summarized below, which directly address the two core research questions.

- (i) We model macroinventions with three critical features – productivity improvement, pervasiveness, and innovation spawning, through which we establish an R&D multiplier that illustrates how trade openness influences the endogenous evolution of GPT. We find substantial gains from trade, when trade costs are high and the North-South wage gap is large.
- (ii) As a result of a virtuous cycle, the Schumpeterian growth channel captured through the R&D multiplier yields a dynamic gain that alone accounts for nearly 90% of the sizable total gains from trade.

Related Literature

This paper is closely related to the literature on trade, innovation, and growth using the Schumpeterian growth mechanism (often employing the BEJK trade structure). [Somale \(2021\)](#) builds a model with directed research effort and shows that trade shocks may change the allocation of R&D resources across sectors. [Buera and Oberfield \(2020\)](#) develop a model of international technology diffusion, which drives endogenous growth and is affected by international trade. [Cai, Li and Santacreu \(2022\)](#) encompass both directed research effort as in [Somale \(2021\)](#) and technology diffusion as in [Eaton and Kortum \(1999\)](#) in a model with input-output linkages. They emphasize the role of cross-country-sector linkages in both trade and technology diffusion in terms of shaping comparative advantages and gains from trade. [Hsieh, Klenow and Nath \(2023\)](#) embed [Klette and Kortum \(2004\)](#) creative destruction mechanism into the BEJK trade structure to study the global competition in innovation and growth and examine the implications on gains from trade. For a broader survey on the relationship between globalization and innovation, see [Akcigit and Melitz \(2022\)](#).

Our study is also related to the broader literature on dynamic gains from trade.³ [Sampson \(2015\)](#) develops an endogenous growth model in which the productivity distribution of firms shifts to the right over time as entrants learn from incumbent firms that survived prior selection. [Perla, Tonetti and Waugh \(2021\)](#) quantify a model of trade and growth in which all firms learn from each other (not just the entrants learning from the incumbents). [Impullitti and Licandro \(2017\)](#) construct a two-country model with process innovation. [Alessandria, Choi and Ruhl \(2021\)](#) evaluate welfare gains from tariff reductions in a model of exporting firms' life cycles that features a tradeoff between new firm creation and export capacity expansion. [Bloom et al. \(2020\)](#) examine gains from trade in the presence of frictions that impede factor mobility, which spurs innovation, increases economic growth rate in the medium run, and results in large gains from trade. [Ravikumar, Santacreu and Sposi \(2019\)](#) investigate a trade model with capital accumulation and fit the model to a sample of 44 countries.⁴

Notably, our work differs from these studies not only in our focus and but also in the modeling mechanism. Specifically, differing from their studies, we model endogenous GPT innovation with three critical features: productivity improvement, pervasiveness and innovation spawning. This enables us to quantify how such mechanisms may affect the dynamic gains from trade and how the resulting dynamic gains may vary with initial income gaps and initial trade costs.

Road Map

The rest of the paper is organized as follows. Section 2 lays out a two-country North-South model of trade, innovation, and growth; Section 3 analyzes how trade affects growth. Section 4 extends the model to a quantitative one and studies the welfare properties. Section 5 quantifies the model, Section 6 conducts the welfare analysis of gains from trade, and Section 7 concludes.

2 Model

We first present a North-South two-country model to clarify the mechanism and intuition of the model, and will extend the model to allow an arbitrary number of countries and

³For earlier studies on dynamic gains from trade, see [Baldwin \(1992\)](#), who shows that the gains in output in the steady state from trade liberalization in a model with capital accumulation can be several times larger than the static gains. The earlier work by [Grossman and Helpman \(1991\)](#) and [Rivera-Batiz and Romer \(1991\)](#) are also related because they are concerned with the implications of trade on the allocation of labor resources as in our paper, even though they are not concerned with gains from trade per se.

⁴Also related is [Akçigit, Ates and Impullitti \(2026\)](#), who study the gains/losses from innovation policy in an open economy.

flexible trade-cost structure in Section 4 for quantitative analysis.

2.1 Environment and Preference

There are two countries, $i = 1, 2$, each with population N_i , which is constant over time. Without loss of generality, we shall label country 1 and 2 as the North and the South, respectively. Time is continuous, with calendar time indexed by t . At time 0, there is a given version of the General Purpose Technology (GPT) indexed by $\nu = 0$; subsequent ν -th innovations lead to the ν -th generations of the GPT. It will be clear that between any two consecutive GPT innovations, the economy stays static.

The life time utility of each individual in country i is:⁵

$$U_i = \int_0^\infty Q_{it} e^{-\rho t} dt,$$

where ρ is the time preference rate, and instantaneous utility Q_{it} is given by the standard CES aggregator:

$$Q_{it} = \left(\int_0^1 (q_{it}(\omega))^{\frac{\sigma-1}{\sigma}} d\omega \right)^{\frac{\sigma}{\sigma-1}},$$

where σ is the elasticity of substitution among differentiated goods which are indexed by ω .

2.2 Innovation

GPT R&D and subsequent innovation occur only in the North. Each good ω requires a blueprint of the production process and production workers to implement such a process to produce. Each production process requires the use of GPT, which is embodied in a “chip” (or an operation system, or engine, etc.). Here, a new generation of GPT has two effects. First, the production process of every good has to be revamped to accommodate this new chip, and hence new ideas about how to produce have to be drawn again. Second, because chips become better over time and allow more flexibility in how to produce the final good ω , the number of ideas that entrepreneurs can draw grows by a constant factor $\gamma > 1$, which resembles the size of the quality ladder as in AH and [Segerstrom, Anant and Dinopoulos \(1990\)](#) and captures the *productivity improvement* feature of the GPT. The GPT monopoly can make each chip good-specific at zero cost.

⁵Note that linear flow utility is assumed here. As will be explained in Section 4.2, adding curvature to the flow utility function will not affect the dynamic component of the welfare.

In the North, there is a unit continuum of GPT innovating firms, each of which engages in hiring R&D labor (researchers), and innovation occurs in a Poisson arrival fashion. So, this market is perfectly competitive and innovating firms take the wages for R&D labor as given. As these firms are ex-ante identical, the GPT arrival rate for an individual firm is the GPT arrival rate for the whole continuum. Once the GPT innovation occurs, without loss of generality, one firm is randomly selected as the new GPT monopoly.⁶ We will formally describe the GPT innovation process in Section 2.4.

Let $\tilde{t}_{i,0}$ denote the number of ideas per unit of the $M_{i,0}$ entrepreneurial labor at time zero. When ν -th generation of GPT is invented, at time ν_+ each unit of the $M_{i,\nu}$ entrepreneurial labor for each good ω works in that instant to come up $\gamma^\nu \tilde{t}_{i,0}$ ideas, and the productivity of each idea is drawn from a Fréchet distribution, $F_i^{\text{draw}}(z) = e^{-z^{-\theta}}$. Firms engage in Bertrand competition as in BEJK, and the best idea prevails. Then, at ν_{++} the GPT monopoly makes the chip ω -specific to each ω and engages in a Nash bargaining with each entrepreneur who owns the best production process to produce ω . For each ω , the bargaining is one-time over the expected profits earned by the ω -firm for the entire duration of the GPT (until it is replaced by the next GPT innovation). The bargaining power of the GPT firm is $\beta \in (0, 1)$. For simplicity, the marginal cost of producing each additional chip is assumed to be zero. This bargaining outcome can be interpreted as the GPT monopoly charging a royalty payment of β times the profit of the ω -firm to use the ω -chip.

Entrepreneurs in both countries need to purchase the ω -chip from GPT innovators. The evolution of the total number of idea draws in each country i is $\tilde{T}_{i,\nu} = M_{i,\nu} \gamma^\nu \tilde{t}_{i,0}$. Let Z_1 and Z_2 denote the top two productivities (as random variables). To utilize the limiting joint distribution of the top two productivities in BEJK, assume that $\tilde{t}_{i,0} = t_{i,0}K$, where K is an arbitrarily large number. Defining $T_{i,\nu} \equiv \tilde{T}_{i,\nu}/K$, we have

$$T_{i,\nu} = M_{i,\nu} \gamma^\nu t_{i,0}. \quad (1)$$

While details are relegated to Appendix A, the limiting joint distribution of the scaled order statistics $K^{-1/\theta} Z_1$ and $K^{-1/\theta} Z_2$ is given by⁷

$$\lim_{K \rightarrow \infty} \Pr [K^{-1/\theta} Z_1 \leq z_1, K^{-1/\theta} Z_2 \leq z_2] = [1 + T_{i,\nu} (z_2^{-\theta} - z_1^{-\theta})] e^{-T_{i,\nu} z_2^{-\theta}}.$$

Thus, with proper rescaling, the c.d.f. of the maximum productivity of these draws and

⁶The model can be straightforwardly modified to the AH setting with R fixed and φ function being constant returns to scale so that there are numerous R&D firms to compete for the lone monopolist in the future.

⁷We thank Erzo Luttmer for his comments, which help clarify the setup here.

that of the top two productivities are given by,

$$F_{i,\nu}(z) = e^{-T_{i,\nu}z^{-\theta}}, \quad z \geq 0, \quad (2)$$

$$F_{i,\nu}(z_1, z_2) = [1 + T_{i,\nu}(z_2^{-\theta} - z_1^{-\theta})]e^{-T_{i,\nu}z_2^{-\theta}}. \quad (3)$$

The BEJK trade model starts with (2) and (3) with given $T_{i,\nu}$. Here, $T_{i,\nu}$ is endogenous and evolves with $M_{i,\nu}$ and GPT innovations.⁸ The cross-country difference in $T_{i,\nu}$ is also affected by $t_{i,0}$.

From this point onward, we refer to $\gamma^\nu t_{i,0}$ as country i 's *knowledge stock* and $T_{i,\nu}$ as its *technology stock*, which depends on how many entrepreneurs $M_{i,\nu}$ use the knowledge stock. As the technology stock evolves according to the generation of the GPT for all differentiated products, this captures both the *pervasiveness* and the *innovation spawning* features of the GPT. Due to historical reasons, the North has a larger initial knowledge stock so that $t_{1,0} > t_{2,0}$. We now turn to the trade environment in BEJK.

2.3 Production and Trade

We briefly explain how the cost and price distributions are determined in BEJK and then collect several useful results from BEJK. For each good ω , the unit cost of supplying to consumers in location n by the k -th most efficient producers located in i is given by,

$$C_{kni}(\omega) = \left(\frac{w_i}{Z_{ki}(\omega)} \right) \tau_{ni},$$

where $\tau_{ni} = 1$ if $n = i$, $\tau_{ni} = \tau$ if $n \neq i$, and the $Z_{1i}(\omega)$ and $Z_{2i}(\omega)$ are random variables whose joint distribution is given by (3). The producer serving market n has unit cost $C_{1n}(\omega) = \min_i \{C_{1ni}(\omega)\}$, and the second lowest cost to supply to n is $C_{2n}(\omega) = \min\{C_{2i^*n}(\omega), \min_{i \neq i^*} \{C_{1in}(\omega)\}\}$, where i^* is the country in which the lowest cost supplier to n is located. Bertrand competition implies that the producer with $C_{1n}(\omega)$ charges $C_{2n}(\omega)$, resulting in a markup of $C_{2n}(\omega)/C_{1n}(\omega)$. Under the CES specification of the utility function, this markup cannot exceed the monopoly markup $\sigma/(\sigma - 1)$ if $\sigma > 1$. Bertrand limit pricing yields:

$$P_n(\omega) = \begin{cases} \min\{C_{2n}(\omega), \frac{\sigma}{\sigma-1}C_{1n}(\omega)\} & \text{if } \sigma > 1 \\ C_{2n}(\omega) & \text{if } \sigma \leq 1 \end{cases}.$$

⁸Note that whereas GPT innovation enhances productivities of all goods, it is not a typical sense of process innovation, which is often considered a firm-level effort.

Using (2) and (3), the joint distribution function of C_{1n} and C_{2n} is $H_n(c_1, c_2) = 1 - e^{-\Phi_n c_1^\theta} - \Phi_n c_1^\theta e^{-\Phi_n c_2^\theta}$, where $\Phi_n = \sum_{i=1}^2 T_i(w_i \tau_{ni})^{-\theta}$, which distills the parameters of productivity distributions, wages, and the trade cost into one single term governing the cost and price distributions. The following properties either recap or extend the BEJK's analytical results that are useful for our analysis.

BEJK Result 1 The probability that country i provides a good at the lowest cost in country n is:

$$\pi_{ni} = \frac{T_i(w_i \tau_{ni})^{-\theta}}{\sum_{k=1}^2 T_k(w_k \tau_{nk})^{-\theta}} = \frac{T_i(w_i \tau_{ni})^{-\theta}}{\Phi_n}.$$

Since there is a continuum of goods, π_{ni} is also the fraction of goods that the consumers at n purchases from i .

BEJK Result 2 In a country n , the probability of buying a good with price lower than p is independent from where the good is purchased from. Thus, π_{ni} is also the share of expenditure of consumers in n on the goods from i :

$$X_{ni} = \pi_{ni} Y_n,$$

where X_{ni} is the total sales from country i to n , and Y_n denote the total (nominal) income in n . Let X_n denote the total sales of producers in n , and note that the above equation differs from the formula in BEJK, $X_{ni} = \pi_{ni} X_n$. In our model, total revenue from firms producing differentiated products is not equal to total income due to the international royalty payments.

BEJK Result 3 Under $\theta + 1 > \sigma$, the price index in country n is:

$$P_n = \eta \Phi_n^{-\frac{1}{\theta}}, \tag{4}$$

where $\eta \equiv \left\{ \left[1 + \frac{(\sigma-1)}{1+\theta-\sigma} \left(\frac{\sigma}{\sigma-1} \right)^{-\theta} \right] \Gamma \left(\frac{1+2\theta-\sigma}{\theta} \right) \right\}^{\frac{1}{1-\sigma}}$ with Γ denoting the gamma function.

BEJK Result 4 A fraction $\theta/(1 + \theta)$ of revenue goes to variable cost.

2.4 Labor Markets

There are three occupations in this economy: entrepreneurs M_i and production workers L_i who are present in both countries and research workers R who are present only in the

North.⁹ Labor is homogeneous; thus, the labor source constraints are

$$R + M_1 + L_1 = N_1, \quad M_2 + L_2 = N_2.$$

2.4.1 Returns to Entrepreneurial and Workers

The labor markets in both countries are perfectly competitive. By BEJK Result 4 and the fact that part of the revenue is paid to the GPT firm, entrepreneurs' expected payoffs $v_{i,\nu}$ and production workers' wages $w_{i,\nu}$ are given by

$$v_{i,\nu} = \frac{1 - \beta}{1 + \theta} \frac{X_{i,\nu}}{M_{i,\nu}}, \quad w_{i,\nu} = \frac{\theta}{1 + \theta} \frac{X_{i,\nu}}{L_{i,\nu}}.$$

In equilibrium, $w_{i,\nu} = v_{i,\nu}$, which implies that $M_{i,\nu} = \frac{1-\beta}{\theta} L_{i,\nu}$. In the South, this implies that

$$L_{2,\nu} = \frac{\theta}{1 - \beta + \theta} N_2, \quad M_{2,\nu} = \frac{1 - \beta}{1 - \beta + \theta} N_2. \quad (5)$$

In the North, we have $N_1 - R_\nu = M_{1,\nu} + L_{1,\nu} = \frac{1-\beta+\theta}{\theta} L_{1,\nu}$, or alternatively,

$$L_{1,\nu} = \frac{\theta}{1 - \beta + \theta} (N_1 - R_\nu) \quad (6)$$

$$M_{1,\nu} = \frac{1 - \beta}{1 - \beta + \theta} (N_1 - R_\nu) \quad (7)$$

2.4.2 Innovator's Optimization

We now shift our attention to research workers. As the aggregate profit earned by all differentiated-product firms is $\frac{X_{1,\nu} + X_{2,\nu}}{1 + \theta}$ at any point in time between ν -th and $\nu + 1$ -th innovations, the value of an innovation is, in a similar fashion to AH, specified by

$$\begin{aligned} V_{\nu+1} &= \beta \int_0^\infty \left[\int_0^t \frac{(X_{1,\nu+1} + X_{2,\nu+1}) e^{-r\tau}}{1 + \theta} d\tau \right] \lambda(R_{\nu+1}) e^{-\lambda(R_{\nu+1})t} dt \\ &= \frac{\beta (X_{1,\nu+1} + X_{2,\nu+1})}{(1 + \theta) [r + \lambda(R_{\nu+1})]}. \end{aligned} \quad (8)$$

where r is the real interest rate, and the Poisson arrival rate λ is an increasing function of R&D labor R_ν hired for innovating a new GPT. Here, the value of innovation is the sum of the GPT profits over time properly discounted by both the real interest rate and the rate

⁹This can be justified by viewing that there is no suitable environment for GPT innovation in the South, and hence, all individuals can only choose between being an entrepreneur or a production worker; native-born research type in the South can only migrate to the North to engage in GPT innovation.

of creative destruction, $\lambda(R_{\nu+1})$.

Labor being homogeneous and the labor market being perfectly competitive imply that the wages for researchers are the same as $w_{1,\nu}$, the North's wages for production workers. Taking $V_{\nu+1}$, the wages, and the price indices as given,¹⁰ a GPT innovator solves:

$$\max_{R_\nu} \lambda(R_\nu) \frac{V_{\nu+1}}{P_{1,\nu+1}} - \frac{w_{1,\nu}}{P_{1,\nu}} R_\nu.$$

This formulation involves the North's price indices at different generations, as what matters is the real profits. Whenever an innovation arrives, the innovator becomes the GPT monopoly. With (8), the first-order condition is:

$$MB \equiv \lambda'(R_\nu) \frac{V_{\nu+1}}{P_{1,\nu+1}} = \frac{\beta(X_{1,\nu+1} + X_{2,\nu+1})}{(1+\theta)P_{1,\nu+1}} \frac{\lambda'(R_\nu)}{r + \lambda(R_{\nu+1})} = \frac{w_{1,\nu}}{P_{1,\nu}} \equiv MC, \quad (9)$$

where the left-hand side is the marginal benefit of R_ν and the right-hand side the marginal cost. We restrict $\lambda'' < 0$ so that the second-order condition $\lambda''(R_\nu) V_{\nu+1}/P_{1,\nu+1} < 0$ holds.

2.4.3 R&D Multiplier

The first-order condition (10) can be further rewritten as:

$$\text{R\&D Multiplier} \equiv \frac{\beta}{1+\theta} \frac{(X_{1,\nu+1} + X_{2,\nu+1})/P_{1,\nu+1}}{w_{1,\nu}/P_{1,\nu}} = \frac{r + \lambda(R_{\nu+1})}{\lambda'(R_\nu)}. \quad (10)$$

The right-hand side of (10) is the AH component capturing the effects of arrival, interest, and creative-destruction rates. Along a balance growth path where $R_\nu = R_{\nu+1} = R$, this term strictly increases with R . Therefore, the left-hand side of the equation can be viewed as an *R&D multiplier* – the larger the R&D multiplier, the more GPT R&D activities in equilibrium. The numerator term $\beta(X_{1,\nu+1} + X_{2,\nu+1})/(1+\theta)P_{1,\nu+1}$ reflects the real royalty payments received from differentiated products firms globally, which depends on real global sales of these products, whereas the denominator term is the marginal cost of R&D captured by the North's real wage. In a special case where R&D Multiplier = growth-induced domestic markup in a closed economy, (10) reduces to the optimization condition in the AH model of Schumpeterian growth. As we will explain in Section 3.2, the R&D multiplier is the key to linking trade and growth.

¹⁰As there is a continuum of GPT innovators, each innovator is an atomless agent, who takes both the expected GPT monopoly revenue $\beta(X_{1,\nu+1} + X_{2,\nu+1})/(1+\theta)$ and the expected rate of creative destruction of his own prey $\lambda(R_{\nu+1})$ as given.

2.4.4 Labor Market Clearing

Using (5) and (6), the labor market clearing conditions are

$$\frac{\theta}{1+\theta}X_{1,\nu} = w_{1,\nu}L_1 = \frac{\theta}{1-\beta+\theta}(N_1 - R_\nu)w_{1,\nu}, \quad (11)$$

$$\frac{\theta}{1+\theta}X_{2,\nu} = w_{2,\nu}L_2 = \frac{\theta}{1-\beta+\theta}N_2w_{2,\nu}. \quad (12)$$

Define $x_\nu \equiv X_{1,\nu}/X_{2,\nu}$, $\chi \equiv N_1/N_2$, and $w_\nu = w_{1,\nu}/w_{2,\nu}$. Substituting, we get

$$x_\nu = \chi \left(1 - \frac{R_\nu}{N_1}\right) w_\nu. \quad (13)$$

2.5 Close the Model

National income is given by

$$\begin{aligned} Y_{1,\nu} &= (1-\beta)\Pi_{1,\nu} + w_{1,\nu}L_1 + \frac{\beta}{1+\theta}(X_{1,\nu} + X_{2,\nu}), \\ Y_{2,\nu} &= (1-\beta)\Pi_{2,\nu} + w_{2,\nu}L_2. \end{aligned}$$

That is, there is an international redistribution of royalty payments from South to North whenever $\beta > 0$.

2.5.1 Goods Markets Clearing

Market clearing condition for final goods is given by

$$Y_{1,\nu} = X_{1,\nu} + \frac{\beta}{1+\theta}X_{2,\nu} = X_{11,\nu} + X_{12,\nu}, \quad (14)$$

$$Y_{2,\nu} = X_{2,\nu} - \frac{\beta}{1+\theta}X_{2,\nu} = X_{21,\nu} + X_{22,\nu}. \quad (15)$$

Using $X_{i,\nu} = \sum_{n=1,2} X_{ni,\nu}$ to combine with the above, we get

$$X_{12,\nu} = X_{21,\nu} + \frac{\beta}{1+\theta}X_{2,\nu}. \quad (16)$$

The lack of balanced trade in final goods is because, in equilibrium, country 1's royalty income from country 2 makes up its excessive net import.

2.5.2 Entrepreneur and Wage Ratios

Using BEJK Results 1 and 2 in conjunction with (14) and (15) and with a few algebraic manipulations, (17) gives the ratio of total revenues proportional to the ratio of entrepreneurship in skill units:

$$\frac{X_{1,\nu}}{X_{2,\nu}} = \left[\frac{\Phi_{1,\nu}}{\Phi_{2,\nu}} \frac{1 + \theta - \beta}{1 + \theta} + \frac{\beta\tau^\theta}{1 + \theta} \right] \frac{M_{1,\nu}}{M_{2,\nu}} w_\nu^{-\theta}, \quad (17)$$

where $\Phi_{n,\nu} = \sum_{i=1,2} T_{i,\nu} (w_{i,\nu} \tau_{ni})^{-\theta}$. With (1) and letting $t_0 = t_{1,0}/t_{2,0}$ and $m_\nu = M_{1,\nu}/M_{2,\nu}$, the above becomes

$$x_\nu = m_\nu w_\nu^{-\theta} \left[\frac{m_\nu t_0 w_\nu^{-\theta} + \tau^{-\theta}}{m_\nu t_0 (w_\nu \tau)^{-\theta} + 1} \frac{1 + \theta - \beta}{1 + \theta} + \frac{\beta\tau^\theta}{1 + \theta} \right].$$

Combining (5), (7), and (13) entails

$$m_\nu = \chi \left(1 - \frac{R_\nu}{N_1} \right) = \frac{x_\nu}{w_\nu}. \quad (18)$$

Combining the above two equations yields

$$w_\nu^{1+\theta} = \frac{m_\nu t_0 w_\nu^{-\theta} + \tau^{-\theta}}{m_\nu t_0 (w_\nu \tau)^{-\theta} + 1} \frac{1 + \theta - \beta}{1 + \theta} + \frac{\beta\tau^\theta}{1 + \theta}. \quad (19)$$

2.5.3 Equilibrium

We choose the North's labor as the numéraire for the general equilibrium in each generation. That is, $w_{1,\nu} = 1$ for all ν , and $w_\nu = 1/w_{2,\nu}$. A *dynamic world equilibrium* is a sequence of a tuple $\left\{ R_\nu, w_\nu, \{L_{i,\nu}, M_{i,\nu}, T_{i,\nu}, P_{i,\nu}\}_{i=1,2} \right\}_{\nu=0}^\infty$ that satisfies, for every generation ν , the two occupational-choice conditions and two labor resource constraints (5), (6), and (7), the evolution of the technology stock and price index (1) and (4) in both countries, the trade condition (19), and the first-order condition for innovators' problems (10).

A simple algorithm is given as follows. First, given the sequence $\{R_\nu\}$, the labor allocation $\{L_{i,\nu}, M_{i,\nu}\}_{i=1,2}$ (and hence the ratio of entrepreneurs between the two countries $\{m_\nu\}$) is given by (5), (6), and (7). Equilibrium wage ratio $\{w_\nu\}$ between two countries is solved from (19). Subsequently, $\{T_{i,\nu}, P_{i,\nu}\}$ are given by (1) and (4). Last, the sequence $\{R_\nu\}_{\nu=0}^\infty$ satisfies (10).

3 Trade and Sustained Growth

Our analysis focuses on a *balanced growth path* (BGP) equilibrium, which is a dynamic world equilibrium with a constant, common growth rate g .¹¹ Along a BGP, wages and total revenues all grow at the common rate $g(R)$, whereas all labor variables are constant.

3.1 Characterization of the Balanced Growth Path

Along the BGP, the subscript ν of all of the stationary variables will be dropped. Given $w_{1\nu} = 1$ by the choice of numeraire, it will be shown shortly that the wage ratio $w_\nu = 1/w_{2\nu}$ and hence $w_{2\nu}$ are both stationary. As a result, the nominal variables $\{X_{i\nu}, Y_{i\nu}\}$ are also stationary. Using (11) and (12) and noting $w_1 = 1$, we have

$$X_1 + X_2 = \frac{1 + \theta}{1 - \beta + \theta} \left(N_1 - R + \frac{N_2}{w} \right). \quad (20)$$

Combining the above with (10), we obtain

$$\frac{r + \lambda(R)}{\lambda'(R)} \frac{P_{1,\nu+1}}{P_{1,\nu}} = \frac{\beta}{1 - \beta + \theta} \left(N_1 - R + \frac{N_2}{w} \right). \quad (21)$$

For the growth rate of the price index, observe that

$$P_{n,\nu+1}^{-\theta} = \eta^{-\theta} \sum_{i=1,2} T_{i,\nu+1} (w_i \tau_{ni})^{-\theta} = \gamma P_{n,\nu}^{-\theta},$$

which implies that for all n ,

$$1 + g_p \equiv \frac{P_{n,\nu+1}}{P_{n,\nu}} = \gamma^{-\frac{1}{\theta}}. \quad (22)$$

Combine (20), (21), and (22), and we obtain

$$\frac{\beta \gamma^{\frac{1}{\theta}} (X_1 + X_2)}{1 + \theta} = \frac{\beta \gamma^{\frac{1}{\theta}}}{1 - \beta + \theta} \left(N_1 - R + \frac{N_2}{w} \right) = \frac{r + \lambda(R)}{\lambda'(R)}. \quad (23)$$

Then, a dynamic equilibrium on a balanced growth path can be obtained by solving $\{R, w, m\}$ jointly using (18), (19), and (23); the wage ratio obtained from trade condition

¹¹We do not study the transitional path for this model because any transitional path likely involves ad hoc assumptions. To see this, observe (9) that the choice of R_ν depends on how the innovators expect the rate the destruction $\lambda(R_{\nu+1})$. Let R^* denote an initial BGP equilibrium R and that $R^{*'}$ the new BGP equilibrium after a shock. GPT innovators can immediately choose a new $R_\nu = R^{*'}$ if they correctly expect $R_{\nu+1} = R^{*'}$, eliminating the transitional path. Thus, any transitional path requires assuming some adjustment frictions or information frictions, either of which can be ad hoc.

(19) is indeed stationary.

Our focus is to understand the growth of real income $y_{i,\nu} = Y_{i,\nu}/P_{i,\nu}$. As $Y_{i,\nu}$ is stationary, (22) implies that $1 + g_y \equiv y_{i,\nu+1}/y_{i,\nu} = \gamma^{\frac{1}{\theta}}$. Under the Poisson process of the GPT innovation and in continuous time, the exponential growth rate of real income is given by $\lambda(R) \ln(\gamma^{\frac{1}{\theta}})$. The larger the GPT R&D effort, the faster real income grows.

Comparing with (10), it is clear that the two sides of the first equality in (23) are two ways to express the R&D multiplier, the endogenous part of which is reduced to the global sales of differentiated products (denominated in the North's wages). By observing the second equality in (23), one sees that had one ignored the effect of R on relative wage w , a unique level of R&D activity R would have been pinned down immediately. In this "partial equilibrium" scenario, the R&D multiplier depends positively on the GPT growth factor (γ) and the North-South wage ratio (w) and negatively on the bargaining power of the GPT firm (β). Intuitively, faster GPT advancement yields both a direct productivity improvement effect and the indirect pervasiveness and innovation spawning effects.

In general, we may rewrite the R&D multiplier to reveal:

$$\begin{aligned} \text{R\&D multiplier} &= \underbrace{\gamma^{\frac{1}{\theta\alpha}}}_{\text{Ladder Size}} \times \underbrace{\frac{\beta}{1+\theta}}_{\text{Profit Rate}} \times \underbrace{\frac{X_1 + X_2}{w_1}}_{\text{Market Size}} \\ &\equiv \text{Ladder Size} \times \text{Profit Rate} \times \text{Market Size}. \end{aligned}$$

Thus, the multiplier depends positively on (i) the step-size of the productivity ladder, (ii) the marginal reward to innovation measured by the profit rate, and (iii) the market size (world revenue in unit of North labor). The underlying channels outlined above can help understand how trade liberalization influences upon innovation and hence growth, where the general equilibrium effect of trade is entirely through the market size channel that contains world revenues and the North-South wage gap. Just how crucial the general equilibrium wage gap w is relative to world revenues? We now proceed to analyze it in the next subsection.

3.2 Openness and Sustained Growth: A virtuous cycle between trade and innovation

This subsection clarifies and explains the mechanism under which trade costs may affect long-run growth. The following analysis focuses on the second equality of (23). Observe that the R&D multiplier consists of two general equilibrium effects of GPT R&D effort: (i) a labor-reallocation effect as a result of occupational choice via the term $N_1 - R$, and (ii) a

general equilibrium wage-gap effect via $w(R)$. Overall, how the multiplier changes in R is ambiguous.

Note that for a given R , a reduction in τ only affects the multiplier via the wage gap w , and the right-hand side of (23) is unaffected. Under the North-South structure, $t_0 = t_{1,0}/t_{2,0} > 1$, we generally expect that the wage gap $w > 1$.¹² Within this two-country framework, trade liberalization tends to reduce this gap (factor price equalization), as it makes the global economy more integrated and spurs the labor demand in the South relative to that in the North. Thus, trade liberalization tends to increase the R&D multiplier for a given R . Because the right-hand side of (23) strictly increases in R , trade liberalization therefore would induce an increase in the equilibrium R as long as the multiplier decreases in R or does not increase in R faster than the right-hand side of (23) around the initial equilibrium R . This is Cases (a) and (b) in Figure 1. But is it possible that the multiplier increases in R faster than the right-hand side as illustrated by Case (c) in Figure 1? This is implausible because it can be ruled out by checking whether the equilibrium R_ν would increase when there is a transitory positive shock to the arrival rate, written as $\tilde{\lambda} = \lambda_0 \lambda(R_\nu)$ with $\lambda_0 > 1$ during period ν and $\lambda_0 = 1$ from $\nu + 1$ onward. For any given R_ν , such a shock implies that the multiplier is unaffected, and the right-hand side decreases because the rate of creative destruction $\lambda(R_{\nu+1})$ is unaffected but $\lambda'(R_\nu)$ increases. Thus, equilibrium R_ν must decrease in Case (c), but this is implausible. That is, Case (c) can be ruled out by Samuelson's Correspondence Principle.

We next compare Cases (a) and (b). As trade liberalization tends to reduce the wage gap, it yields a direct positive impact on the R&D multiple. When the general equilibrium effect of R on the wage gap w is small, Case (a) arrives. With sufficiently large (but not too large) general equilibrium effect, Case (b) emerges. Compared to Case (a), Case (b) tends to induce more innovation but yield a smaller R&D multiple: the dampening general equilibrium effect requires more R&D effort to achieve optimal rewards to innovators. In either case, the positive relationship between R&D effort and R&D multiple ensures a *virtuous cycle* between trade and innovation.

The key intuition here is that *aggregate world revenue and hence aggregate labor demand in the unit of the North's labor* $X_{1,\nu+1} + X_{2,\nu+1}$ *increase* in face of trade liberalization because a more integrated economy implies a stronger demand for the South's labor (relative to

¹²In addition to $t_0 > 1$, the differences in model primitives between the two countries include relative population size χ between the North and the South and the fact that GPT innovation occurs only in the North, the latter of which should also contribute to $w > 1$. Thus, the only possibility for $w > 1$ not to hold is a very large $\chi > 1$. In the sample for our quantitative analysis, the average population size (measured by employment) of the North countries is only 0.47 of that of the South countries. In the benchmark equilibrium in the quantitative analysis, the employment-weighted average wage of the North countries is 9.7 times larger than that of the South countries.

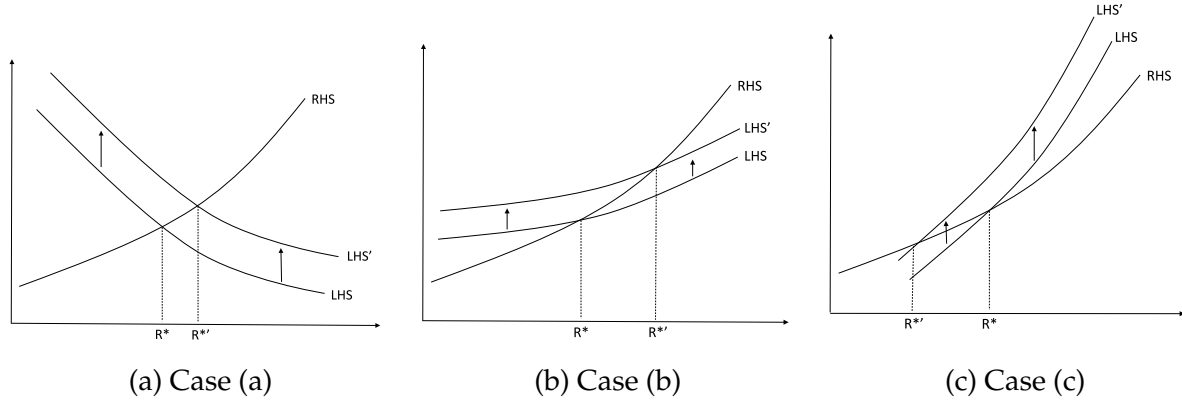


Figure 1: Effect of Trade Liberalization on R&D

the North's) which reduces the wage gap. When R increases as a result, the arrival of new GPT becomes faster, and the real income of each country also grows faster. Thus, the nexus between trade and innovation can generate a virtuous cycle, leading to a higher sustained growth path in a global world.

4 Quantitative Model and Welfare Gains from Trade

We now extend the theoretical model in the previous sections to a quantitative one that allows for an arbitrary number of countries and flexible trade costs between any pair of countries. We also investigate properties pertaining to welfare gains from trade.

4.1 Quantitative Model

4.1.1 Model generalization

There are I countries, each of which is indexed by $i, n \in \{1, \dots, I_N, \dots, I\}$, where the first I_N countries are the North countries, and there are $I - I_N$ South countries. Each country has a population L_i . To deliver a unit of a good to country n from i , $\tau_{ni} \geq 1$ units need to be shipped from i . Assume that $\tau_{nn} = 1$. The model setup is the same as in Section 2 except for the following two features.

First, the production function of a product ω is now extended to incorporate intermediate inputs as in BEJK:

$$y_i(\omega) = Bz_i(\omega)[\ell_i(\omega)]^\alpha[b_i(\omega)]^{1-\alpha}, \quad (24)$$

where b_i denotes the bundles of intermediate inputs used, α the labor share for production, and $B = [\alpha^\alpha(1-\alpha)^{1-\alpha}]^{-1}$ a normalizing constant for a clean expression of the unit

cost.

Second, assume that GPT innovators are multi-national corporations (MNCs) that set up branches in each North country. A GPT innovator hires R units of composite labor input that combines researchers from the North countries via a Cobb-Douglas production function.

$$R = \frac{\prod_{i=1}^I R_i^{\mu_i}}{\prod_{i=1}^I \mu_i^{\mu_i}}$$

such that $\sum_{i=1}^I \mu_i = 1$, and $\mu_i = 0$ if i is a South country. The Poisson arrival rate of a new GPT is given by $\lambda(R)$. As the GPT monopoly is an MNC, assume that the royalty payments received are distributed to its branch in country i by its labor share μ_i .

4.1.2 Equilibrium conditions

We relegate the complete description of the equilibrium conditions to Appendix B.1. Here we describe some of the conditions derived from the two above-mentioned parts of the quantitative model. For the labor market, follow the same procedure as that in Section 2.4, one obtains similar labor allocation given $\{R_{i,\nu}\}_{i=1}^I$:

$$M_{i,\nu} = \frac{1 - \beta}{1 - \beta + \theta\alpha} (N_i - R_{i,\nu}) \quad (25)$$

$$L_{i,\nu} = \frac{\theta\alpha}{1 - \beta + \theta\alpha} (N_i - R_{i,\nu}). \quad (26)$$

An innovating firm's cost minimization problem is

$$\begin{aligned} \min \quad & \sum_{i \in \text{North}} \frac{w_{i,\nu}}{P_{i,\nu}} R_{i,\nu} \\ \text{s.t.} \quad & \frac{\prod_{i=1}^I R_{i,\nu}^{\mu_i}}{\prod_{i=1}^I \mu_i^{\mu_i}} \geq R_\nu. \end{aligned}$$

Let $w_\nu^R \equiv \prod_{i=1}^I w_{i,\nu}^{\mu_i}$ and $P_\nu \equiv \prod_{i=1}^I P_{i,\nu}^{\mu_i}$. The Cobb-Douglas structure implies that the aggregate price index for the composite input R_ν is given by

$$\frac{w_\nu^R}{P_\nu} = \prod_{i=1}^I \left(\frac{w_i}{P_{i,\nu}} \right)^{\mu_i}.$$

In equilibrium, the demand for researchers in each country satisfies

$$\begin{aligned} \frac{w_{i,\nu} R_{i,\nu}}{P_{i,\nu}} &= \mu_i \frac{w_\nu^R R_\nu}{P_\nu} \\ \sum_i \frac{w_{i,\nu} R_{i,\nu}}{P_{i,\nu}} &= \frac{w_\nu^R R_\nu}{P_\nu} \end{aligned} \quad (27)$$

The value of an innovation at generation $\nu + 1$ is

$$V_{\nu+1} = \frac{\beta \sum_{i=1}^I X_{i,\nu+1}}{(1+\theta)[r + \lambda(R_{\nu+1})]}.$$

As assumed above, the GPT innovating firms are jointly owned by people in the North countries with the share of country i given by μ_i . So, the real value of a new innovation should be deflated by $P_{\nu+1} = \prod_{i=1}^I P_{i,\nu+1}^{\mu_i}$.¹³ Thus, a GPT innovator's problem is

$$\max_{R_\nu} \frac{\lambda(R_\nu) V_{\nu+1}}{P_{\nu+1}} - \frac{w_\nu^R R_\nu}{P_\nu}. \quad (28)$$

Similar to (10), the first-order condition can be written as

$$\frac{\beta}{1+\theta} \frac{\left(\sum_{i=1}^I X_{i,\nu+1}\right) / P_{\nu+1}}{w_\nu^R / P_\nu} = \frac{r + \lambda(R_{\nu+1})}{\lambda'(R_\nu)}, \quad (29)$$

where the left-hand side is the R&D multiplier. As a fraction μ_i of royalty payment to the GPT firm is given to the branch in country i , country i 's national income is given by

$$Y_{i,\nu} = \frac{1-\beta}{1+\theta} X_{i,\nu} + w_{i,\nu} L_{i,\nu} + \frac{\beta \mu_i}{1+\theta} \sum_{n=1}^I X_{n,\nu}. \quad (30)$$

4.1.3 Balanced growth path and growth rates

By Walras' law and for the general equilibrium in each generation, we set $w_\nu^R = 1$. Thus, the nominal variables $\{w_{i,\nu}, X_{i,\nu}, Y_{i,\nu}\}$ and the labor allocation variables $\{R_\nu, R_{i,\nu}, L_{i,\nu}, M_{i,\nu}\}$ are both stationary along the BGP; the subscript ν for these variables along the BGP can,

¹³Alternatively, one can assume that the MNC owner lives in a particular country i , and thus the problem can be written as

$$\max_{R_\nu} \frac{\lambda(R_\nu) V_{\nu+1}}{P_{i,\nu+1}} - \frac{w_\nu^R R_\nu}{P_\nu}.$$

It is readily verified that this alternative formulation is qualitatively similar to the benchmark formulation in (28).

therefore, be dropped. As the technology stock $T_{i,\nu}$ grows by a factor γ for each new innovation, unit costs and price indices generally decline over time.

Complete equilibrium conditions along the BGP are relegated to Appendix B.2. The basic idea is that given an equilibrium composite research labor input R , the complete set of the above-mentioned stationary variables, along with *detrended* unit costs and price indices, can be solved in the static cross-sectional equilibrium, similar to BEJK. Then, following the procedure in the two-country model in Section 3.1, the (negative) growth rate of the price index along the BGP, g_p , is given by

$$1 + g_p \equiv \frac{P_{n,\nu+1}}{P_{n,\nu}} = \gamma^{-\frac{1}{\theta\alpha}}. \quad (31)$$

Combining the above with (29), equilibrium R on the BGP can be solved from

$$\frac{\beta\gamma^{\frac{1}{\theta\alpha}}}{1+\theta} \sum_{i=1}^I X_i = \frac{r + \lambda(R)}{\lambda'(R)}, \quad (32)$$

where the left-hand side is the R&D multiplier.

For welfare calculations, we will need to know the growth rate in real income $y_{i,\nu} = Y_{i,\nu}/P_{i,\nu}$, denoted as g_y . As $Y_{i,\nu}$ is stationary, (B.15) implies that $1 + g_y \equiv y_{i,\nu+1}/y_{i,\nu} = \gamma^{\frac{1}{\theta\alpha}}$. Under the Poisson process of the GPT innovation and in continuous time, the exponential growth rate of real income is given by $k_y \equiv \lambda(R) \ln \left(\gamma^{\frac{1}{\theta\alpha}} \right)$. The corresponding annual growth rate is $[y(1) - y(0)]/y(0) = e^{k_y} - 1 = \gamma^{\frac{\lambda(R)}{\theta\alpha}} - 1$.

4.2 Welfare Gains from Trade

Assume that the economy is on the BGP from time zero, and thus the lifetime utility of country i 's representative agent on the BGP viewed at $t = 0$ is given by

$$U_i = \int_0^\infty Q_{i,0} e^{-(\rho - k_y)t} dt = \frac{1}{\rho - k_y} \times \frac{Y_{i,0}}{N_i} \times \frac{1}{P_{i,0}}.$$

To ensure finite lifetime utility, we impose a modified Brock-Gale condition in a fashion similar to that in Bond, Wang and Yip (1996): $\rho > \max_R \lambda(R) \ln(\gamma)$. This condition will be met if the maximum arrival rate is not too high and the ladder step size, γ , is not too large; we will check this in our quantitative analysis. Also, note that if a certain curvature were to be added to the flow utility function, the dynamic component $1/(\rho - k_y)$ remains the same.

Following the trade literature, we examine welfare changes in relative terms:

$$\begin{aligned}
\frac{U'_i}{U_i} &= \frac{\rho - k_y}{\rho - k'_y} \times \frac{Y'_{i,0}}{Y_{i,0}} \times \frac{P_{i,0}}{P'_{i,0}} = \frac{\rho - k_y}{\rho - k'_y} \times \frac{Y'_{i,0}/w'_{i,0}}{Y_{i,0}/w_{i,0}} \times \frac{w'_{i,0}/P'_{i,0}}{w_{i,0}/P_{i,0}} \\
&= \frac{\rho - k_y}{\rho - k'_y} \times \frac{Y'_{i,0}/w'_{i,0}}{Y_{i,0}/w_{i,0}} \times \left(\frac{\pi'_{ii}}{\pi_{ii}} \right)^{-\frac{1}{\theta\alpha}} \\
&\equiv GR_i \times IG_i \times ACR_i.
\end{aligned} \tag{33}$$

That is, the relative welfare changes can be decomposed into three terms. The first term, denoted by GR_i , is *the growth rate effect*. As the exponential growth rate of real income $k_y = \lambda(R) \ln \left(\gamma^{\frac{1}{\theta\alpha}} \right)$, this is the major channel for which the dynamic effect of R&D kicks in. Intuitively, a larger R&D effort advances technology faster and entails a larger welfare improvement. The mechanism illustrated in Section 3 shows that trade can induce more R&D effort and hence contribute to welfare improvement.

The last term in (33) captures the relative change in real wages, which is exactly the ACR formula for welfare gains from trade in a static model. To see this, simply use BEJK Results 1 and 3 and note that $\tau_{ii} = 1$ by assumption, and we have

$$\left(\frac{\pi'_{ii}}{\pi_{ii}} \right)^{-\frac{1}{\theta\alpha}} = \left(\frac{\sum_k T_k (C_k \tau_{ik})^{-\theta}}{\sum_k T_k (C'_k \tau'_{ik})^{-\theta}} \right)^{-\frac{1}{\theta\alpha}} \left(\frac{C'_i \tau'_{ii}}{C_i \tau_{ii}} \right)^{\frac{1}{\alpha}} = \frac{w'_i/P'_i}{w_i/P_i}.$$

Thus, the relevant trade elasticity is $\theta\alpha$. As is well known, the static gains from trade in the ACR framework are reflected in changes in trade flows.

The second term in (33) is denoted as IG_i , the *income-gains effect*. This captures the relative changes in the *income-wage ratio*. In the ACR framework, this term disappears because of the assumptions that (1) trade is balanced, that (2) aggregate profit is a constant share of the total revenue, and that (3) labor is inelastically supplied. When trade is balanced, total income equals total revenue. Then, the latter two assumptions, along with the Cobb-Douglas production function, imply a constant income-wage ratio because the total labor costs $w_i L_i$ is a constant share of total income. By adopting the BEJK structure, assumptions (2) and (3) hold, but the first assumption is violated due to the royalty payments to the GPT monopoly. Thus, this income-gains effect reflects the North's gains from trade stemming from the North's ownership of GPT. To have a closer look at this effect, rewrite (30) using BEJK Result 4:

$$\frac{Y_{i,\nu}}{w_{i,\nu}} = \frac{1 - \beta + \theta\alpha}{\theta\alpha} L_{i,\nu} + \frac{\beta\mu_i}{\theta\alpha} \sum_{n=1}^I \frac{w_{n,\nu}}{w_{i,\nu}} L_{n,\nu}. \tag{34}$$

For South countries there are no income-gains. Using $\mu_i = R_i = 0$ and (26), the above equation is reduced to $Y_{i,\nu}/w_{i,\nu} = N_i$, which means that per capita income equals the wage. For North countries, the income-gains effect is generally positive unless the terms of trade effect on relative wages are very unfavorable (see Section 6.1).

Note that the growth-rate effect does not fully reflect the true dynamic gains from trade because changes in the research effort R and R_i also affect the income-gains and the ACR components through general equilibrium effects. To account for the true dynamic gains from trade, we compare our model with a purely static version of the model in which $\kappa = 0$. Obviously, both the equilibrium R and the growth rate are zero under such a parameter constraint. From (25) and (26), it is immediate that all labor-allocation variables $\{M_i, L_i\}$ become constant (which is a feature of the BEJK model). Also, growth rate $k_y = 0$ and hence the growth-rate effect disappears in this static model. To isolate the contribution of dynamics on the total gains from trade (called dynamic gains from trade), one could write:

$$\frac{U'_i}{U_i} = \frac{\frac{U'_i}{U_i}}{\frac{U'_i}{U_i}\bigg|_{\text{static}}} \times \frac{U'_i}{U_i}\bigg|_{\text{static}} = GR_i \times \frac{IG_i \times ACR_i}{IG_i|_{\text{static}} \times ACR_i|_{\text{static}}} \times (IG_i|_{\text{static}} \times ACR_i|_{\text{static}}), \quad (35)$$

where the sub-label of static indicates the corresponding value under the static model. The true dynamic gains are thus the first two multiplicative terms, which reflect the growth-rate effect in the dynamic model and the general equilibrium effects of trade on the income-gains and ACR components that are not captured by the static model. Equivalently, we can write (35) as

$$\frac{\ln \left(GR_i \times \frac{IG_i \times ACR_i}{IG_i|_{\text{static}} \times ACR_i|_{\text{static}}} \right)}{\ln \left(\frac{U'_i}{U_i} \right)} = 1 - \frac{\ln (IG_i|_{\text{static}} \times ACR_i|_{\text{static}})}{\ln \left(\frac{U'_i}{U_i} \right)}, \quad (36)$$

and one can simply compute the share of the dynamic gains (which we sometimes call *dynamic share* in short) by calculating the right-hand side of the above equation after computing the gains from trade in the static model.

5 Quantification

We calibrate our model to match the world economy during 2000-2014. The first task in the calibration is to reasonably define the North and South countries. Our approach is to

Table 1: Parameterization

Panel A: Preset Parameters			
Parameter	Value	Meaning	Notes
ρ	0.03	Time preference rate	Standard in the literature.
r	0.05	Real interest rate	
γ	1.1017	GPT innovation ladder size	Aghion et al. (2019)
θ	5.03	Trade elasticity	Head and Mayer (2014)
Panel B: Calibrated Parameters			
Parameter	Value	Meaning	Target
τ_{ni}	-	Trade costs	Calibrated by the fixed-effect gravity equation and the model structure.
$t_{i,0}$	-	Initial technology stock	
β	0.074	The bargaining power parameter of the GPT firm	Targeting profit rate of 15.4%.
κ	2.04	Efficacy of the GPT innovation	Jointly calibrated by targeting BGP annual growth rate of 1.898%, and BGP R&D employment share in North countries to 0.58%.
ε	0.20	Curvature parameter of the GPT innovation	

take the Penn World Tables (PWT9.0) data and select those countries with at least two-thirds of the U.S. real GDP per worker as the North.¹⁴ The countries under consideration are based on the availability of other datasets used in the calibration, including Centre d’Etudes Prospectives et d’Informations Internationales (CEPII) data, Global Report of Global Entrepreneurship Monitor (GEM), World Input Output Database (WIOD),¹⁵ World Development Indicators (WDI), and Penn World Tables (PWT) 9.0. There are 52 countries in our sample. There are 19 North countries and 33 South countries. The complete list is provided in Table D.1 in the Appendix. Unless otherwise mentioned, all of the data values used in calibration are averages during 2000-2014.

Succinct information regarding the calibration is provided in Table 1. The following provides the details of calibration; some further details are relegated to the appendices.

Data and preset parameters We first retrieve a set of parameters from the literature. As the Fréchet shape parameter of the productivity distribution, θ , is the trade elasticity, we set $\theta = 5.03$, which is the preferred value from [Head and Mayer \(2014\)](#) synthesis on the gravity equation literature. For the ladder size of productivity upgrading, we set $\gamma = 1.1017$, following [Aghion et al. \(2019\)](#).¹⁶ Following much of the macro-growth

¹⁴The GDP measure used is output at constant PPP in 2011 million US\$ (rgdpo). The employment data is obtained from the WDI. All data are averaged over 2000-2014.

¹⁵The 2016 release of the WIOD is used. See <http://www.wiod.org/home>.

¹⁶More specifically, this number is the average among the estimates of step size in three different periods in the data (1983-1993, 1993-2003, 2003-2013). See Table 11 of [Aghion et al. \(2019\)](#).

literature, we set the time preference rate ρ to 0.03, and the real interest rate r to 0.05.

Share of intermediate inputs We use the Social Economic Account (SEA) from the World Input Output Database (WIOD) 2014 to calculate $1 - \alpha$. At the two-digit level, the SEA provides information about country-industry-specific gross output and the compensation for intermediate inputs at current basic prices. Taking the US for the benchmark value and aggregating across industries, we obtain $1 - \alpha = 0.44$. This calibration of $1 - \alpha$ implies that we interpret the single fundamental input (labor) in the model broadly as the composite input consisting of both labor and capital in the data.

R&D share and GPT's bargaining power Based on (27), the R&D share μ_i for each North country i is calibrated via:

$$\mu_i = \frac{\frac{w_i R_i}{P_i}}{\sum_{i=1}^{I_N} \frac{w_i R_i}{P_i}},$$

where w_i/P_i is the country-specific real wages proxied by the real GDP per worker,¹⁷ and R_i is proxied by the number of researchers obtained from the WDI.

To calibrate β , note that this parameter directly affects the profit share of revenue of differentiated-product firms, as well as the royalty payments received by the GPT, which are the GPT's profit. Using the calibrated μ_i 's, β is calibrated by targeting the profit rate of 0.154. We obtain $\beta = 0.074$. See further details in Appendix C.1.

Trade costs and relative technology stocks The complete details are relegated to Appendix C.2, and here we briefly describe how trade costs and relative technology stocks are estimated/calibrated. Using trade flows data and geography-related variables from CEPII¹⁸ and given values of trade elasticity θ , bilateral trade costs τ_{ni} 's are estimated from the gravity equation implied by the model structure with a standard approach such as that in Head and Mayer (2014). The average of bilateral trade costs τ_{ni} is 3.3. Given estimated trade costs, together with values of θ and α , the initial knowledge stock $t_{i,0}$ can be backed out from the model structure, as in Fieler (2011) and Ravikumar, Santacreu and Sposi (2019). In particular, combining the model structure with the gravity equation, the exporter fixed effects D_i^{exp} is given by $T_i C_i^{-\theta}$, where the unit cost C_i is a function of the technology stock $\{T_i\}_{i=1}^I$. Thus, $\{T_i\}_{i=1}^I$ can be solved using the following system of

¹⁷Using the GDP per worker to proxy real wages is consistent with our calibration of the share of intermediate inputs that interpret the labor input in our model broadly.

¹⁸There are multiple sources of CEPII's trade flows data, and the UN Comtrade one is used here.

equations, given the exporter fixed effects $\{\hat{D}_i^{exp}\}_{i=1}^I$ and bilateral trade costs $\{\tau_{ni}\}$ estimated from the gravity equation, values of (θ, α) , and nominal wages w_i^{data} for each country.¹⁹

$$T_i C_i^{-\theta} = \exp(\hat{D}_i^{exp}) \quad (37)$$

$$C_i = (w_i^{data})^\alpha P_i^{1-\alpha} \quad (38)$$

$$P_i = \left(\sum_{m=1}^I T_m [C_m \tau_{i,m}]^{-\theta} \right)^{-\frac{1}{\theta}}. \quad (39)$$

With data values of M_i from the GEM, we then compute $t_{i0} \propto T_i/M_i$. In sum, the relative technology stocks $\{t_{i0}\}$ are how the model rationalizes the estimated exporter fixed effects, consistent with estimated trade costs and observed country-specific wages and adjusted for entrepreneurial activities.

Innovation parameters For our quantitative implementation, we specify the arrival rate as: $\lambda(R) = \kappa R^\epsilon$, with $\kappa > 0$, $\epsilon \in (0, 1)$, a form commonly used in the innovation and growth literature. Finally, the two parameters κ and ϵ are solved simultaneously to match the following two targets. The first target is the annual real income growth rate. Specifically, we first calculate the annual growth rates of GDP per worker for all of the countries in our sample combined for each year during 1980–2014.²⁰ Then, we take the geometric average of these growth rates and obtain 1.8977%. The model counterpart of the annual growth rate is given by $\gamma^{\frac{\lambda(R)}{\theta\alpha}} - 1$ (see Section 4.1.3). The second target is the employment share of R&D researchers, $\sum_{i \in \text{North}} R_i^{data} / \sum_{i \in \text{North}} N_i^{data}$. Using the WDI data, the employment share of researchers is 0.58%. The resulting $(\kappa, \epsilon) = (2.04, 0.20)$.

6 Quantitative Analysis

The primary goal of our quantitative analysis is to evaluate the welfare gains from trade, with a focus on the total gains and the importance of dynamic gains. As is standard, we measure welfare gains from trade based on the following two scenarios: (i) *compared with*

¹⁹In the expression of the price index, we have renormalized the constant in the price index $\eta = 1$ (see BEJK Result 3). This is without loss of generality as what matters for equilibrium is the relative technology stock.

²⁰To match the *long-run* growth rate and to avoid concerns about business cycles and decade-specific economic conditions, we lengthen the period beyond 2000–2014 for calculating the average annual growth rate. This period, however, includes the Great Recession, and thus the calculated long-run growth rate can be considered a lower bound, which tends to yield conservative estimates of welfare gains.

autarky: what are the gains from trade when the global economy transitions from autarkic economies to the benchmark model with estimated bilateral trade costs?; (ii) *compared with less-costly trade*: what are the gains from trade when the global economy transitions from the benchmark model to the case where all bilateral trade costs are reduced by 25%.

For each scenario, we first present the total gains from trade and decompose them into growth-rate, income-gains, and ACR effects. As mentioned in Section 4.2, the growth-rate effect in the simple decomposition is not necessarily the dynamic component of the total gains, if the general equilibrium effects are non-negligible. Thus, we compare with the static model in which $\kappa = 0$ (zero arrival rate) to find the “true” dynamic share of the gains from trade. We conduct sensitivity analyses at the end of the section.²¹

6.1 Gains from Trade

We first study the gains from trade, i.e., the first scenario, which is a good benchmark largely capturing rounds of tariff reductions during the post-WWII era with the formation of GATT and then WTO.²² In this scenario, the BGP annual growth rate of real income changes from 1.538% under autarky to 1.8977% under the benchmark. Table 2 reports, for each country in our sample, the total gains, gains due to each of the three components, and their respective shares in the total gains. The table also reports the average and population-weighted average of these figures for each set of countries (North and South) and for all countries. When making comparison between the North and the South, we shall refer to population-weighted figures to reflect the role played by the market size. In contrast, when we position a particular country’s gain within the North or the South, we shall utilize unweighted simple average figure to display a country’s relative gain to overall. The table also reports the effect on global welfare, which is defined as the population-weighted average of country-specific individual utility.²³

The cross-country weighted average of total gains is 30.6%, with the North gaining slightly more than the South (32.1% vs 30.2%). The impact of trade on global welfare is 36.0%. In the balanced growth model, the growth-rate gains are the same, at 27.4%, across all countries, and the weighted average of the share of the growth-rate component is 89.5% with the respective weighted average for the North and the South being 85.5%

²¹We also study the role of intermediate inputs, of which the details are relegated to Appendix E.

²²Various data put together by Bown and Irwin (2017) and Bagwell, Bown and Staiger (2016) suggest an over 80% tariff cut on average, from about 22% in 1947 to only 4% in 1999.

²³Note that this is different from the population-weighted average of the gains from trade (or their components). Because the global welfare is already a weighted sum of individual countries’ individual utility, the effect of trade on this measure cannot be decomposed in the same way as we decompose an individual country’s welfare, which is multiplicative in the three components.

Table 2: Simple Decomposition of Gains from Trade (moving from autarky to trade)

Country	iso3	North/South	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)	Share of GR Gains (%)	Share of IG Gains (%)	Share ACR Gains (%)
Australia	AUS	North	33.20	27.4	3.37	2.43	82.54	10.15	7.31
Belgium	BEL	North	59.94	27.4	4.44	28.09	45.72	7.41	46.86
Canada	CAN	North	39.34	27.4	3.49	8.44	69.67	8.87	21.46
Switzerland	CHE	North	44.71	27.4	0.82	16.48	61.3	1.83	36.87
Germany	DEU	North	34.28	27.4	1.47	5.4	79.95	4.3	15.75
Denmark	DNK	North	43.59	27.4	3.59	12.59	62.88	8.24	28.88
Spain	ESP	North	37.13	27.4	4.49	5.24	73.8	12.08	14.12
Finland	FIN	North	46.01	27.4	5.0	13.6	59.57	10.87	29.56
France	FRA	North	41.98	27.4	7.46	7.11	65.28	17.77	16.94
United Kingdom	GBR	North	31.32	27.4	-0.92	4.84	87.49	-2.94	15.45
Greece	GRC	North	56.63	27.4	16.6	12.63	48.4	29.31	22.3
Ireland	IRL	North	44.91	27.4	-1.34	18.85	61.02	-2.98	41.96
Italy	ITA	North	31.75	27.4	0.02	4.33	86.32	0.06	13.62
Japan	JPN	North	28.06	27.4	-0.24	0.89	97.68	-0.87	3.18
Netherlands	NLD	North	45.44	27.4	6.03	12.01	60.3	13.26	26.44
Norway	NOR	North	35.74	27.4	-1.14	9.47	76.67	-3.18	26.5
Singapore	SGP	North	34.89	27.4	-1.8	9.29	78.54	-5.16	26.62
Sweden	SWE	North	35.07	27.4	-0.94	8.61	78.14	-2.68	24.54
United States	USA	North	26.42	27.4	-1.89	0.9	103.72	-7.14	3.42
Argentina	ARG	South	33.10	27.4	0	5.69	82.8	0	17.2
Bosnia and Herzegovina	BIH	South	102.68	27.4	0	75.27	26.69	0	73.31
Brazil	BRA	South	29.13	27.4	0	1.73	94.07	0	5.93
Chile	CHL	South	34.85	27.4	0	7.44	78.65	0	21.36
China	CHN	South	28.34	27.4	0	0.94	96.69	0	3.31
Colombia	COL	South	36.89	27.4	0	9.48	74.29	0	25.71
Ecuador	ECU	South	46.46	27.4	0	19.05	58.99	0	41.01
Guatemala	GTM	South	56.61	27.4	0	29.2	48.41	0	51.59
Croatia	HRV	South	65.89	27.4	0	38.49	41.59	0	58.41
Hungary	HUN	South	46.59	27.4	0	19.19	58.82	0	41.18
India	IDN	South	28.91	27.4	0	1.51	94.79	0	5.21
Iran	IRN	South	36.24	27.4	0	8.83	75.63	0	24.37
Iceland	ISL	South	62.50	27.4	0	35.1	43.85	0	56.15
Jamaica	JAM	South	81.30	27.4	0	53.89	33.71	0	66.29
Korea	KOR	South	30.27	27.4	0	2.86	90.55	0	9.45
Latvia	LVA	South	72.04	27.4	0	44.63	38.04	0	61.96
Mexico	MEX	South	30.72	27.4	0	3.32	89.21	0	10.79
Malaysia	MYS	South	36.24	27.4	0	8.84	75.62	0	24.38
New Zealand	NZL	South	33.73	27.4	0	6.33	81.25	0	18.76
Panama	PAN	South	53.94	27.4	0	26.54	50.81	0	49.19
Peru	PER	South	38.49	27.4	0	11.09	71.19	0	28.81
Poland	POL	South	38.40	27.4	0	11.0	71.37	0	28.63
Portugal	PRT	South	38.76	27.4	0	11.36	70.7	0	29.3
Romania	ROU	South	42.75	27.4	0	15.34	64.11	0	35.89
Russia	RUS	South	31.06	27.4	0	3.66	88.23	0	11.77
Slovenia	SVN	South	63.33	27.4	0	35.93	43.27	0	56.73
Thailand	THA	South	31.95	27.4	0	4.54	85.78	0	14.22
Trinidad & Tobago	TTO	South	63.63	27.4	0	36.23	43.07	0	56.93
Turkey	TUR	South	34.48	27.4	0	7.07	79.48	0	20.52
Uganda	UGA	South	72.12	27.4	0	44.71	38.0	0	62.0
Uruguay	URY	South	54.32	27.4	0	26.91	50.45	0	49.55
Venezuela	VEN	South	36.56	27.4	0	9.16	74.95	0	25.05
South Africa	ZAF	South	32.98	27.4	0	5.57	83.1	0	16.9
Avg (weighted)	-	-	30.62	27.4	0.14	3.07	89.51	0.46	10.03
North Avg (weighted)	-	North	32.07	27.4	0.67	3.99	85.45	2.1	12.45
South Avg (weighted)	-	South	30.23	27.4	0	2.82	90.66	0	9.34
Avg	-	-	43.76	27.4	0.93	15.42	62.62	2.13	35.25
North Avg	-	North	39.50	27.4	2.55	9.54	69.39	6.47	24.15
South Avg	-	South	46.22	27.4	0	18.81	59.29	0	40.71
Global Welfare	-	-	35.95	-	-	-	-	-	-
North Welfare	-	North	36.21	-	-	-	-	-	-
South Welfare	-	South	35.23	-	-	-	-	-	-

and 90.7%. In other words, the growth-rate component, on average, accounts for most of the gains, even though for certain countries, it can be exceeded by the ACR gains. The share of the growth rate component is higher for the South, as the North has higher ACR gains and income gains on average.

There is considerable variation in the ACR components across countries. The weighted average of the ACR gains among the North countries is 4.0%, larger than that among the South countries (2.8%). The ACR theory suggests that gains from trade are larger when domestic expenditure shares are smaller, which tends to be the case when country sizes or trade barriers are small. Hence, the larger ACR gains enjoyed by the North countries may be explained by the fact that the South countries' average population size is more than twice as large as the North countries' and that the North countries' trade barriers are, on average, smaller than the South ones'.

Recall from Section 4.2 that the income-gains component is zero by construction for the South countries. There is a large variation across the North countries in this component, but the importance of this component is only 2.1% for the North countries. Some countries (seven out of 19 North countries) even suffer a loss in this term. A detailed analysis of the changes in the components of (34) reveals that most of the variation comes from the second component, $\frac{\beta\mu_i}{\theta\alpha} \sum_{n=1}^I \frac{w_{n,\nu}}{w_{i,\nu}} L_{n,\nu}$, which can be divided into a sum over the South countries and a sum over the North ones. A general effect of such a trade shock is that the South countries' wages relative to a North country i rise; thus, the first sum generally benefits North countries in this component. Those North countries that suffer from income-gains loss (such as the US) are those whose relative wage to other North countries rises so much such that this negative relative-wage effect in the second sum dominates the positive relative-wage effect in the first sum. Despite these negative income gains for some North countries, both the weighted and unweighted averages of this component remain positive.

In short, the growth-rate component plays a dominant role, followed by the ACR gains, and the income-gains component is the smallest among the three, though they are nonnegligible for some North countries (namely, France, Greece, and the Netherlands, all exceeding 5%).

As mentioned, the simple decomposition exercises above do not reflect the *true dynamic gains* from trade because the GPT innovation (R) also affects wages that affect the IG and the ACR measures. To rectify this problem, we obtain pure static gains via a counterfactual exercise by shutting down the sole growth driver from GPT innovation. Specifically, this is by setting $\kappa = 0$, and hence $R = 0$ in equilibrium. In this case, $GR = 1$ by construction, but IG and ACR are also adjusted to exclude the R&D effect (see [35]) – so

these components are generally different from those reported in Table 2. By subtracting pure static gains from the total gains, we obtain the true dynamic gains from trade, and the dynamic share can then be calculated by (36). The results are summarized in Table 3.

Unlike in the simple decomposition, the dynamic gains are not constant, varying from 24.2% to 27.4%. The weighted average of the dynamic share is 89.1%, with the respective weighted average for the North and South being 83.5% and 90.6%. These values are rather similar to the growth-rate component in Table 2, indicating that the general equilibrium effects via GPT innovation R are small. This is intuitive because even though GPT innovation is critical to the overall welfare gains from trade, it accounts for only a small share of the labor force and therefore does not induce large effects via wages and trade. Thus, the growth-rate gains actually provide a reasonably good approximation to the dynamic gains.

It is interesting to observe that the U.S. incurs much lower total gains from trade (26.42%, compared to the simple average gain of the North countries about 40%). Moreover, its gain is essentially all coming from the dynamic gain, while the North dynamic share averages only about 2/3. Within the North, the Asian giant (Japan) has very similar gains and dynamic share to the U.S., whereas the major EU-3 (France, Germany and UK) incur greater total gains with less dynamic shares.

By contrast, many South countries enjoy significantly higher total gains, with a simple average of about 46.22%, driven mainly by a larger static gain (about 18.86%). Among these, the two largest economies (China and India) incur drastically lower total gains (only about 28%). While both countries have dynamic shares exceeding 90% (compared to the simple average of the South countries about 50%), their static gains are negligible (compared to the simple average of the South of almost 20%), thereby explaining the cause of low total gains.

6.2 Gains from Trade Liberalization

To implement the second scenario, a 25% reduction in the estimated trade costs is computed by $\tau'_{n,i} = 0.75 \times (\tau_{n,i} - 1) + 1$. We summarize the results of simple decomposition in Panel B of Table 4. For the ease of comparison, Panel A of Table 4 presents a similar summary for the first scenario (autarky to estimated trade costs).

In this scenario, the growth rate of real income increases from 1.8977% under benchmark to 1.8989%. The weighted average of the total gains and growth-rate gains are 3.7% and 0.11%, respectively, whereas the same numbers are 30.6% and 27.4% in the first scenario. The fact that the total gains are smaller is intuitive, as the changes in trade costs

Table 3: Dynamic vs. Static Gains (moving from autarky to trade)

Country	iso3	North/South	Total gains from trade (%)	Static gains from trade (%)	Dynamic Gains from Trade (%)	Dynamic share (%)
Australia	AUS	North	33.20	6.71	26.49	79.79
Belgium	BEL	North	59.94	33.37	26.57	44.32
Canada	CAN	North	39.34	12.68	26.66	67.77
Switzerland	CHE	North	44.71	17.70	27.01	60.41
Germany	DEU	North	34.28	7.32	26.96	78.65
Denmark	DNK	North	43.59	17.10	26.48	60.76
Spain	ESP	North	37.13	10.79	26.35	70.95
Finland	FIN	North	46.01	19.77	26.24	57.03
France	FRA	North	41.98	15.96	26.01	61.97
United Kingdom	GBR	North	31.32	4.04	27.28	87.09
Greece	GRC	North	56.63	32.45	24.18	42.70
Ireland	IRL	North	44.91	17.63	27.28	60.74
Italy	ITA	North	31.75	4.60	27.15	85.51
Japan	JPN	North	28.06	0.81	27.25	97.13
Netherlands	NLD	North	45.44	19.24	26.20	57.65
Norway	NOR	North	35.74	8.43	27.31	76.41
Singapore	SGP	North	34.89	7.90	27.00	77.37
Sweden	SWE	North	35.07	7.81	27.26	77.74
United States	USA	North	26.42	-0.25	26.68	100.96
Argentina	ARG	South	33.10	5.70	27.40	82.77
Bosnia and Herzegovina	BIH	South	102.68	75.45	27.22	26.51
Brazil	BRA	South	29.13	1.73	27.40	94.06
Chile	CHL	South	34.85	7.45	27.39	78.61
China	CHN	South	28.34	0.94	27.40	96.69
Colombia	COL	South	36.89	9.50	27.39	74.25
Ecuador	ECU	South	46.46	19.08	27.37	58.93
Guatemala	GTM	South	56.61	29.24	27.36	48.34
Croatia	HRV	South	65.89	38.60	27.29	41.41
Hungary	HUN	South	46.59	19.26	27.34	58.67
India	IDN	South	28.91	1.51	27.40	94.78
Iran	IRN	South	36.24	8.86	27.38	75.55
Iceland	ISL	South	62.50	35.20	27.30	43.68
Jamaica	JAM	South	81.30	53.97	27.33	33.61
Korea	KOR	South	30.27	2.87	27.40	90.53
Latvia	LVA	South	72.04	44.76	27.28	37.86
Mexico	MEX	South	30.72	3.32	27.40	89.18
Malaysia	MYS	South	36.24	8.85	27.39	75.59
New Zealand	NZL	South	33.73	6.34	27.39	81.19
Panama	PAN	South	53.94	26.58	27.36	50.73
Peru	PER	South	38.49	11.11	27.39	71.14
Poland	POL	South	38.40	11.04	27.36	71.26
Portugal	PRT	South	38.76	11.41	27.35	70.57
Romania	ROU	South	42.75	15.40	27.35	63.98
Russia	RUS	South	31.06	3.67	27.39	88.19
Slovenia	SVN	South	63.33	36.04	27.29	43.09
Thailand	THA	South	31.95	4.55	27.40	85.75
Trinidad & Tobago	TTO	South	63.63	36.29	27.34	42.97
Turkey	TUR	South	34.48	7.11	27.37	79.38
Uganda	UGA	South	72.12	44.81	27.31	37.87
Uruguay	URY	South	54.32	26.94	27.38	50.40
Venezuela	VEN	South	36.56	9.18	27.39	74.90
South Africa	ZAF	South	32.98	5.59	27.39	83.06
Avg (weighted)	-	-	30.62	3.35	27.27	89.05
North Avg (weighted)	-	North	32.07	5.29	26.78	83.51
South Avg (weighted)	-	South	30.23	2.83	27.40	90.63
Avg	-	-	43.76	16.66	27.10	61.93
North Avg	-	North	39.50	12.84	26.65	67.48
South Avg	-	South	46.22	18.86	27.36	59.20

Table 4: Simple Decomposition of Gains from Trade (Comparing Two Scenarios)

Panel A: From Autarky to Benchmark Trade Costs				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	30.62	27.4	0.14	3.07
North Avg (weighted)	32.07	27.4	0.67	3.99
South Avg (weighted)	30.23	27.4	0	2.82
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	89.51		0.46	10.03
North Avg (weighted)	85.45		2.1	12.45
South Avg (weighted)	90.66		0	9.34
Panel B: 25% Reduction in Trade Costs from the Benchmark				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	3.72	0.11	0.0	3.61
North Avg (weighted)	3.88	0.11	0.01	3.76
South Avg (weighted)	3.68	0.11	0	3.57
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	3.03		0.05	96.92
North Avg (weighted)	2.9		0.24	96.85
South Avg (weighted)	3.06		0	96.94

are smaller than in the first scenario. However, the decomposition exhibits an interesting pattern. The weighted average of the share of the growth rate component is drastically reduced from 89.5% to 3.0%.

To understand why the share of the growth-rate component is larger when trade costs are higher, recall our theoretical analysis in Section 3.2 based on the two-country model, that shows that trade promotes GPT innovation. The key mechanism can be observed from the second equality of (23). For a given R , the right-hand side is fixed, whereas the left-hand side changes because of the changes in the North-South wage ratio w ; thus, the BGP equilibrium GPT R&D effort R critically depends on the wage gap. Under higher trade costs, the wage gap w is larger. Moving from autarky to the benchmark trade costs thus reduces the wage gap w drastically and results in a larger increase in R compared with a 25.0% reduction in trade costs. In other words, when trade barriers are high, there is less incentive to conduct GPT innovation because of the smaller market size in terms of the North's labor. Put differently, the ratio of marginal benefit to the marginal cost of GPT innovation becomes smaller when the trade barriers are high.

Second, the ACR gains are generally much larger in the second scenario than in the first. The weighted average of this component and its share in the total gains are 3.6% and 96.9%, respectively, whereas the same numbers in the first scenario are 3.0% and 10.0%. The intuition is that, by Shephard's Lemma, the ACR statistic essentially reflects the direct

Table 5: Dynamic vs Static Gains (Comparing Two Scenarios)

Panel A: From Autarky to Benchmark Trade Costs				
	Total gains (%)	Static gains (%)	Dynamic gains (%)	Dynamic share (%)
Avg (weighted)	30.62	3.35	27.27	89.05
North Avg (weighted)	32.07	5.29	26.78	83.51
South Avg (weighted)	30.23	2.83	27.4	90.63
Panel B: 25% Reduction in Trade Costs from the Benchmark				
	Total gains (%)	Static gains (%)	Dynamic gains (%)	Dynamic share (%)
Avg (weighted)	3.722	3.614	0.107	2.883
North Avg (weighted)	3.882	3.764	0.118	3.049
South Avg (weighted)	3.678	3.574	0.104	2.836

effect of trade costs on prices, which operates primarily through imported goods. Compared with the first scenario, trade costs are lower in the second, so demand for imported goods tends to be larger, amplifying the direct price effect. In addition, the South's wages also amplify the direct effect of trade costs on prices because they reflect the marginal costs in the South. As trade costs are lower in the second scenario, the South's wages tend to be closer to the North's, amplifying the direct price effect and resulting in a larger ACR statistic.

Table 5 reports the true dynamic gains for both scenarios. For the second scenario and on weighted-average terms, the dynamic share is 0.107%, which is rather close to the above-mentioned share of the growth rate component. Similar to the first scenario, this indicates that the general equilibrium effects of GPT innovation effort via trade and wages are small.

6.3 Sensitivity Analysis

We conduct the following three sensitivity analyses. First, we check what occurs if the trade elasticity is chosen to be 4, as suggested by [Simonovska and Waugh \(2014\)](#). Second, we experiment with different sizes of the productivity ladder, γ . Third, we experiment with different sizes of the GPT's bargaining power parameter, β . In each case, the model is recalibrated. Table 6 reports the results. Again, the pattern of larger dynamic gains in the first scenario than in the second remains, as well as the pattern that the growth-rate gains approximate the true dynamic gains. Thus, we report only the simple decomposition in the first scenario and put the benchmark results in Panel A for ease of comparison.

The first observation is that the ACR gains and income gains are relatively similar across these cases, and most of the variation in the total gains from trade is explained

Table 6: Sensitivity Analysis

Panel A: From Autarky to Benchmark Trade Costs (Benchmark)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	30.62	27.4	0.14	3.07
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	89.51		0.46	10.03
Panel B: From Autarky to Benchmark Trade Costs ($\theta = 4$)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	11.79	8.05	0.42	3.32
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	68.29		3.56	28.14
Panel C: From Autarky to Benchmark Trade Costs ($\gamma = (\gamma_0 - 1) \times 1.1 + 1$)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	30.76	27.54	0.14	3.07
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	89.55		0.46	9.98
Panel D: From Autarky to Benchmark Trade Costs ($\gamma = (\gamma_0 - 1) \times 0.9 + 1$)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	30.48	27.27	0.14	3.07
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	89.46		0.47	10.08
Panel E: From Autarky to Benchmark ($\beta = 0.5 \times \beta_0$)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	49.23	46.08	0.04	3.11
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	93.6		0.08	6.32
Panel F: From Autarky to Benchmark ($\beta = 1.5 \times \beta_0$)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	18.48	15.18	0.25	3.06
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	82.13		1.33	16.54

by the growth-rate component. Adopting $\theta = 4$, a lower value than the benchmark, entails larger ACR gains and much smaller growth-rate gains and total gains. It is well understood in the trade literature that lower trade elasticity entails larger ACR gains. To understand why the growth-rate gains are much smaller, again note that the model annual growth rate $\gamma^{\frac{\lambda(R)}{\theta\alpha}} - 1$ needs to match the same data counterpart. Thus, when the trade elasticity is smaller, the arrival rate parameters (κ, ϵ) have to be smaller. This results in smaller dynamic gains.

For alternative values of γ , we consider 50% above and below the benchmark ladder size: $\gamma = (\gamma_0 - 1) \times 1.5 + 1$ and $\gamma = (\gamma_0 - 1) \times 0.5 + 1$. The results are that a larger γ induces larger growth-rate gains, but only slightly. Note that γ affects only the innovation parameters in the calibration procedure, which explains why the static gains are almost intact. A larger γ implies smaller κ and ϵ in order to rationalize the same data annual growth rate. However, the direct effect of a larger γ slightly dominates the effect of smaller κ and ϵ to entail a slight increase in the growth rate and total gains. The fact that the two effects are opposite to each other explains why the quantitative results are quite robust to the choice of γ .

For alternative values of β , we also consider 50% above and below the benchmark value: $\beta = 1.5 \times \beta_0$ and $\beta = 0.5 \times \beta_0$. The result clearly shows that as β increases, the dynamic and total welfare gains decrease. To see this, observe (32) and note that when β increases, the equilibrium R tends to increase as the right-hand side of (32) is an increasing function of R . This is intuitive, as greater bargaining power for the GPT firm incentivizes GPT R&D. The fact that the model's annual real income growth rate must match the data counterpart implies that the innovation parameters must decrease relative to the benchmark values, thereby resulting in smaller dynamic and total gains from trade.

In summary, even across these large-scale sensitivity exercises, total gains from trade remain sizable, all above 10%. Moreover, the dynamic component remains dominant, accounting for at least two-thirds of the total gains.

7 Concluding Remarks

This paper develops a general equilibrium model of trade, innovation, and growth based on the evolution of general purpose technology. The central mechanism is that trade liberalization changes the return to GPT innovation. Because GPT innovation is performed in the North while the GPT is used by differentiated-product firms in both the North and the South, the incentive to innovate depends on world revenue from GPT-using goods

relative to the wage cost of Northern R&D. When trade barriers are initially high, liberalization substantially narrows the North–South wage gap and raises global market size in units of Northern labor. This strengthens the R&D incentive, accelerates GPT innovation, and generates a virtuous cycle between trade and growth.

The welfare analysis shows how this mechanism translates into gains from trade. The long-run welfare change can be decomposed into a growth-rate effect, an income-gains effect, and the standard ACR statistic. In the quantitative exercises, total gains from trade are large, and the dynamic component accounts for most of these gains when the economy moves from autarky to observed trade costs. By contrast, for a moderate reduction in already-low trade costs, the dynamic share is much smaller. Thus, dynamic gains from trade are not a fixed markup over static gains; they depend on the initial level of trade barriers through their effect on the North–South wage gap and the incentive to conduct GPT R&D. Across scenarios, the growth-rate effect closely approximates the true dynamic gains, suggesting that the main quantitative force is faster GPT-driven growth rather than large additional general-equilibrium feedback through wages and revenues.

It is clear that GPT innovation in our model can be combined with other types of trade models with imperfect competition, in which the profits/rents of firms can be shared with the GPT firms in a similar fashion. Hence, our model can be modified to incorporate other trade mechanisms of interest, such as variety expansion *a la* [Krugman \(1980\)](#) or selection *a la* [Melitz \(2003\)](#). Nevertheless, an advantage of choosing the BEJK trade structure is that, as GPT improvements spur innovations in differentiated products, the BEJK structure implies creative destruction (e.g., firm entry and exit), as documented by [Jovanovic and Rousseau \(2005\)](#). Our model mechanism can also be generalized to incorporate social learning or international technology diffusion, such as [Eaton and Kortum \(1999\)](#), [Buera and Oberfield \(2020\)](#), and [Perla, Tonetti and Waugh \(2021\)](#). This may be an interesting avenue for future research because it will enable the decomposition of dynamic welfare gains from trade into various technology-related mechanisms.

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Appendix

In this Not-Intended-for-Publication appendix, we provide detailed mathematical derivations of the benchmark and the extensions, as well as detailed calibration strategies.

A Joint Distribution of Top Two Productivities

The c.d.f. of a Fréchet distribution with scaling parameter S and shape parameter θ is given by $F(z) = e^{-Sz^{-\theta}}$. Following standard procedures, the joint distribution of the top two order statistics Z_1 and Z_2 from N draws from the Fréchet distribution is

$$\Pr[Z_1 \leq z_1, Z_2 \leq z_2] = e^{-NSz_2^{-\theta}} + N \left[e^{-S(z_1^{-\theta} - z_2^{-\theta})} - 1 \right] e^{-NSz_2^{-\theta}}. \quad (\text{A.1})$$

In our model, $S = 1$ since $F_i^{\text{draw}}(z) = e^{-z^{-\theta}}$ and $N = \tilde{T}_{i,\nu} = M_{i,\nu}\gamma^\nu \tilde{t}_{i,0}$. Recall from the main text that $\tilde{t}_{i,0} = t_{i,0}K$ and $T_{i,\nu} = \tilde{T}_{i,\nu}/K$. Plug these into (A.1), and we have

$$\begin{aligned} \Pr[Z_1 \leq z_1, Z_2 \leq z_2] &= e^{-\tilde{T}_{i,\nu}z_2^{-\theta}} + \tilde{T}_{i,\nu} \left[e^{-(z_1^{-\theta} - z_2^{-\theta})} - 1 \right] e^{-\tilde{T}_{i,\nu}z_2^{-\theta}} \\ &= e^{-T_{i,\nu}Kz_2^{-\theta}} + T_{i,\nu}K \left[e^{-(z_1^{-\theta} - z_2^{-\theta})} - 1 \right] e^{-T_{i,\nu}Kz_2^{-\theta}}. \end{aligned}$$

Consider the joint distribution of the re-scaled top two order statistics $K^{-1/\theta}Z_1$ and $K^{-1/\theta}Z_2$, and we have

$$\begin{aligned} \Pr[K^{-1/\theta}Z_1 \leq z_1, K^{-1/\theta}Z_2 \leq z_2] &= \Pr[Z_1 \leq K^{1/\theta}z_1, Z_2 \leq K^{1/\theta}z_2] \\ &= e^{-T_{i,\nu}Kz_2^{-\theta}} + \frac{e^{-(K^{-1}z_1^{-\theta} - K^{-1}z_2^{-\theta})} - 1}{K^{-1}} T_{i,\nu} e^{-T_{i,\nu}Kz_2^{-\theta}}. \end{aligned}$$

As $\lim_{K \rightarrow \infty} \frac{e^{-(K^{-1}z_1^{-\theta} - K^{-1}z_2^{-\theta})} - 1}{K^{-1}} = z_2^{-\theta} - z_1^{-\theta}$, we have

$$\lim_{K \rightarrow \infty} \Pr[K^{-1/\theta}Z_1 \leq z_1, K^{-1/\theta}Z_2 \leq z_2] = [1 + T_{i,\nu}(z_2^{-\theta} - z_1^{-\theta})] e^{-T_{i,\nu}Kz_2^{-\theta}}.$$

B Mathematical Details of the Quantitative Model

B.1 Equilibrium Conditions

The evolution of the number of ideas follows

$$T_{i,\nu} = M_{i,\nu}\gamma^\nu t_{i,0}. \quad (\text{B.2})$$

From the production function (24), the cost for one unit of output is given by

$$C_{i,\nu} \equiv w_{i,\nu}^\alpha P_{i,\nu}^{1-\alpha}. \quad (\text{B.3})$$

The BEJK structure implies that trade share and price index are given by

$$\pi_{ni,\nu} = \frac{T_{i,\nu}(C_{i,\nu}\tau_{ni})^{-\theta}}{\sum_k^I T_{k,\nu}(C_{k,\nu}\tau_{nk})^{-\theta}} \quad (\text{B.4})$$

$$P_n = \eta \left[\sum_{i=1}^I T_{i,\nu} (C_{i,\nu} d_{ni})^{-\theta} \right]^{-\frac{1}{\theta}}, \quad (\text{B.5})$$

where $\eta \equiv \left\{ \left[1 + \frac{\sigma-1}{1+\theta-\sigma} \left(\frac{\sigma}{\sigma-1} \right)^{-\theta} \right] \Gamma \left(\frac{1+2\theta-\sigma}{\theta} \right) \right\}^{\frac{1}{1-\sigma}}$ with Γ denoting the gamma function. An innovating firm's cost minimization problem is

$$\begin{aligned} \min \quad & \sum_{i \in \text{North}} \frac{w_{i,\nu}}{P_{i,\nu}} R_{i,\nu} \\ \text{s.t.} \quad & \frac{\prod_{i=1}^I R_{i,\nu}^{\mu_i}}{\prod_{i=1}^I \mu_i^{\mu_i}} \geq R_\nu. \end{aligned}$$

Let $w_\nu^R \equiv \prod_{i=1}^I w_{i,\nu}^{\mu_i}$ and $P_\nu \equiv \prod_{i=1}^I P_{i,\nu}^{\mu_i}$. The aggregate price index for the composite input R_ν is therefore given by

$$\frac{w_\nu^R}{P_\nu} = \prod_{i=1}^I \left(\frac{w_i}{P_{i,\nu}} \right)^{\mu_i}. \quad (\text{B.6})$$

In equilibrium, the demand for researchers in each country satisfies

$$R_{i,\nu} \frac{w_{i,\nu}}{P_{i,\nu}} = \mu_i \frac{w_\nu^R}{P_\nu} R_\nu. \quad (\text{B.7})$$

Note that for the South countries, $R_{i,\nu} = 0$ as $\mu_i = 0$. For the labor market, follow the same procedure as that in Section 2.4, one obtains similar labor allocation given $\{R_{i,\nu}\}_{i=1}^I$:

$$M_{i,\nu} = \frac{1-\beta}{1-\beta+\theta\alpha} (N_i - R_{i,\nu}) \quad (\text{B.8})$$

$$L_{i,\nu} = \frac{\theta\alpha}{1-\beta+\theta\alpha} (N_i - R_{i,\nu}). \quad (\text{B.9})$$

Let $E_{n,\nu}$ be the total expenditure on differentiated products in country n , and thus the total sales of differentiated products produced by country i $X_{i,\nu}$ must satisfy $X_{i,\nu} =$

$\sum_{n=1}^I \pi_{ni,\nu} E_{n,\nu}$. Then, BEJK Result 4 ($w_{i,\nu} L_{i,\nu} = \alpha \theta X_{i,\nu} / (1 + \theta)$) implies that

$$w_{i,\nu} L_{i,\nu} = \frac{\alpha \theta}{1 + \theta} \sum_{n=1}^I \pi_{ni,\nu} E_{n,\nu}. \quad (\text{B.10})$$

A country's income consists of entrepreneurs' payoffs, wage payments to production workers, and potential royalty revenue. As a fraction μ_i of GPT's royalty revenue is given to the branch in country i , country i 's income is given by

$$Y_{i,\nu} = \frac{1 - \beta}{1 + \theta} X_{i,\nu} + w_{i,\nu} L_{i,\nu} + \frac{\beta \mu_i}{1 + \theta} \sum_{n=1}^I X_{n,\nu}. \quad (\text{B.11})$$

Total expenditure consists of consumption expenditure on final goods and the expenditure on intermediate inputs:

$$\begin{aligned} E_{n,\nu} &= Y_{n,\nu} + \frac{\theta(1 - \alpha)}{1 + \theta} X_{n,\nu} \\ &= \frac{1 - \beta + \theta}{\theta \alpha} w_{n,\nu} L_{n,\nu} + \frac{\beta \mu_n}{\theta \alpha} \sum_{i=1}^I w_{i,\nu} L_{i,\nu}, \end{aligned} \quad (\text{B.12})$$

where the second equality make uses of (B.11) together with BEJK Result 4. Plugging (B.12) into (B.10), we obtain

$$w_{i,\nu} L_{i,\nu} = \sum_{n=1}^I \pi_{ni,\nu} \left(\frac{1 - \beta + \theta}{1 + \theta} w_{n,\nu} L_{n,\nu} + \frac{\beta \mu_n}{1 + \theta} \sum_{i=1}^I w_{i,\nu} L_{i,\nu} \right). \quad (\text{B.13})$$

Conditioned on a sequence of $\{R_\nu\}_{\nu=0}^\infty$ and given a sequence of wages and research labor $\{w_{i,\nu}, R_{i,\nu}\}_{i,\nu}$, labor allocation and evolution of the technology stock $\{M_{i,\nu}, L_{i,\nu}, T_{i,\nu}\}$ are pinned down by (B.8), (B.9), and (B.2), unit cost and price index $\{C_{i,\nu}, P_{i,\nu}\}_{i,\nu}$ are solved from (B.3) and (B.5), and trade shares $\{\pi_{ni,\nu}\}_{n,i,\nu}$ are given by (B.4). The fixed point of $\{R_{i,\nu}\}_{i,\nu}$ is solved from (B.6) and (B.7). Then, the fixed point of wages $\{w_{i,\nu}\}_{i,\nu}$ can be solved from (B.13). Then, aggregate sales of differentiated products and national income are given by BEJK Result 4 and (B.11). At this stage, every variable is solved given a sequence of $\{R_\nu\}_{\nu=0}^\infty$ subject to a choice of numeraire for the general equilibrium at each generation. Without loss of generality, we set $w_\nu^R = 1$ for all ν .

The value of an innovation at generation $\nu + 1$ is

$$V_{\nu+1} = \frac{\beta \sum_{i=1}^I X_{i,\nu+1}}{(1 + \theta)[r + \lambda(R_{\nu+1})]}.$$

Assume that the GPT innovating firms are jointly owned by people in the North countries with the share of owners in country i is given by μ_i . So, the real value of a new innovation should be deflated by $P_{\nu+1} = \prod_{i=1}^I P_{i,\nu+1}^{\mu_i}$.²⁴ Thus, a GPT innovator's problem is

$$\max_{R_\nu} \frac{\lambda(R_\nu) V_{\nu+1}}{P_{\nu+1}} - \frac{w_\nu^R}{P_\nu} R_\nu.$$

Similar to (10), the first-order condition can be written as

$$\frac{\beta}{1+\theta} \frac{\left(\sum_{i=1}^I X_{i,\nu+1}\right) / P_{\nu+1}}{w_\nu^R / P_\nu} = \frac{r + \lambda(R_{\nu+1})}{\lambda'(R_\nu)}, \quad (\text{B.14})$$

where the left-hand side is the R&D multiplier. This last equation is the condition for $\{R_\nu\}_{\nu=0}^\infty$.

B.2 Balanced Growth Path and Growth Rates

In this subsection, we characterize the equilibrium conditions along the BGP and growth rates. As mentioned, we set $w_\nu^R = 1$ (but it is sometimes written out for easier interpretation); thus, the nominal variables $\{w_{i,\nu}, X_{i,\nu}, Y_{i,\nu}\}$ and the labor allocation variables $\{R_\nu, R_{i,\nu}, L_{i,\nu}, M_{i,\nu}\}$ are both stationary along the BGP. As the technology stock $T_{i,\nu}$ grows by a factor γ for each new innovation, unit costs, and price indices generally decline over time. The declining unit costs and price indices are detrended so that the detrended variables are stationary along the BGP:

$$\tilde{C}_i \equiv \frac{C_{i,\nu}}{(\sum_k \gamma^\nu t_{k,0})^{-\frac{1-\alpha}{\alpha\theta}}}, \quad \tilde{P}_i \equiv \frac{P_{i,\nu}}{(\sum_k \gamma^\nu t_{k,0})^{-\frac{1}{\alpha\theta}}}.$$

Similar to the previous subsection, we first consider the equilibrium given R , (normalized) wages, and research labor $\{w_i, R_i\}_i$, the following equilibrium conditions allows us

²⁴Alternatively, one can assume that the MNC owner lives in a particular country i , and thus, the problem can be written as

$$\max_{R_\nu} \frac{\lambda(R_\nu) V_{\nu+1}}{P_{i,\nu+1}} - \frac{w_\nu^R R_\nu}{P_\nu}.$$

It is readily verified that this alternative formulation is qualitatively similar to the benchmark formulation in (28).

to solve for the stationary variables $\{M_i, L_i, \tilde{C}_i, \tilde{P}_i, \pi_{ni}\}$:

$$\begin{aligned} M_i &= \frac{1 - \beta}{1 - \beta + \theta\alpha} (N_i - R_i) \\ L_i &= \frac{\theta\alpha}{1 - \beta + \theta\alpha} (N_i - R_i) \\ \tilde{C}_i &= w_i^\alpha \tilde{P}_i^{1-\alpha} \\ \tilde{P}_i &= \eta \left(\sum_{k=1}^I t_{k,0} \right)^{\frac{1}{\theta}} \left[\sum_{k=1}^I M_k t_{k,0} \left(\tilde{C}_{k,\nu} d_{ik} \right)^{-\theta} \right]^{-\frac{1}{\theta}} \\ \pi_{ni} &= \frac{M_{i,\nu} t_{i,0} (\tilde{C}_{i,\nu} \tau_{ni})^{-\theta}}{\sum_{k=1}^I M_{i,\nu} t_{i,0} (\tilde{C}_{k,\nu} \tau_{nk})^{-\theta}}, \end{aligned}$$

which also verify that $\tilde{C}_i$ and $\tilde{P}_i$ are indeed stationary. Then, $\{R_i\}_i$ is solved from

$$R_i w_i = \mu_i \frac{\tilde{P}_i}{\tilde{P}} R,$$

and the fixed point of wages $\{w_i\}$ can be obtained from

$$w_i L_i = \sum_{n=1}^I \pi_{ni} \left(\frac{1 - \beta + \theta}{1 + \theta} w_n L_n + \frac{\beta \mu_n}{1 + \theta} \sum_{i=1}^I w_i L_i \right).$$

Then, using BEJK Result 4, $X_i = (1 + \theta) w_i L_i / \alpha \theta$. Following the procedure in the two-country model in Section 3.1, the (negative) growth rate of the price index along the BGP, g_p , is given by

$$1 + g_p \equiv \frac{P_{n,\nu+1}}{P_{n,\nu}} = \gamma^{-\frac{1}{\theta\alpha}}. \quad (\text{B.15})$$

Combining the above with (B.14), equilibrium R on the BGP can be solved from

$$\frac{\beta \gamma^{\frac{1}{\theta\alpha}}}{1 + \theta} \sum_{i=1}^I X_i = \frac{r + \lambda(R)}{\lambda'(R)},$$

where the left-hand is the R&D multiplier. Next, for welfare calculations, we will need to know the growth rate in real income $y_{i,\nu} = Y_{i,\nu} / P_{i,\nu}$, denoted as g_y . As $Y_{i,\nu}$ is stationary, (B.15) implies that $1 + g_y \equiv y_{i,\nu+1} / y_{i,\nu} = \gamma^{\frac{1}{\theta\alpha}}$.

C Calibration

C.1 GPT's bargaining power

To calibrate β , note that this parameter directly affects the profit share of revenue of differentiated-product firms, as well as the royalty payments received by the GPT, which are the GPT's profit. That is, given calibrated μ_i 's, we solve

$$(\text{Profit rate})_{\text{USA}} = \frac{(1 - \beta) \frac{X_{\text{USA}}}{1+\theta} + \mu_{\text{USA}} \times \frac{\beta \sum_{n=1}^I X_n}{1+\theta}}{X_i + \mu_{\text{USA}} \times \frac{\beta \sum_{n=1}^I X_n}{1+\theta}},$$

where we proxy X_i by country i 's gross output from the WIOD, averaged across years between 2000-2014. Using the profit rate of 0.154, we obtain $\beta = 0.074$. The following explains how we obtain the profit rate.

In the data, firm revenues can be divided into variable costs, fixed costs, and profits. There are no fixed costs in our model; hence, there is a tension between the following two views of calibration. The first view is to treat fixed costs as part of profits. Note that firm markups are, by definition, the ratio of prices to marginal costs, and that [De Loecker, Eeckhout and Unger \(2020\)](#) document that the rise in markups over time is likely due to the rise in fixed costs. This supports viewing fixed costs as part of the profits in our model. The second view is to attribute the fixed costs to be a part of the variable costs, as everything can change in the long run. This view makes the concept of markup closer to “pure profit” or market power. [De Loecker, Eeckhout and Unger \(2020\)](#) compute markups using the Compustat North America for publicly listed firms, and there is an item SG&A in this data accounting for a firm's various overhead costs (such as R&D and advertising, etc.). The SG&A share of sales is 0.178. Profit as a share of sales is 0.065. When SG&A is part of the profit, then the profit rate is 0.243. The simple average between the narrow sense of profit rate, 0.065, and the broader sense of profit rate, 0.243, is 0.154.

C.2 Trade Costs and Relative Technology Stock

Let E_n denote the total expenditure of country n and E_{ni} the expenditure of country n on country i 's goods. BEJK Results 1 and 2 imply that the following gravity equation:

$$X_{ni} = \pi_{ni} E_n = \frac{T_i (C_i \tau_{ni})^{-\theta}}{\Phi_n} \times E_n.$$

Taking the logarithm of both sides of the above equation

$$\ln(X_{ni}) = \ln(T_i C_i^{-\theta}) + \theta \ln(\tau_{ni}^{-\theta}) - \ln(\Phi_n E_n)$$

Assuming the functional form of trade costs is a function of geography:

$$\ln(\tau_{ni}^{-\theta}) = b_1 \ln(Dist_{ni}) + b_2 \times \text{contig}_{ni} + b_3 \times \text{comlang_off}_{ni} + e_{ni} \quad (\text{C.16})$$

where $Dist_{ni}$ is the distance between n and i , contig_{ni} the dummy equal to 1 if countries are contiguous, comlang_off_{ni} the dummy for whether the two countries share a common official or primary language, and e_{ni} the error term. The empirical specification of gravity equation, therefore, becomes

$$\ln(X_{ni,t}) = D_i^{exp} + D_n^{imp} + D_t + b_1 \ln(Dist_{ni}) + b_2 \times \text{contig}_{ni} + b_3 \times \text{comlang_off}_{ni} + e_{ni,t},$$

where D_i^{exp} , D_n^{imp} , and D_t are exporter, importer, and year fixed effects, respectively. To estimate the above specification, trade flow (in thousands current US\$) during 2000-2014 from UN Comtrade as $X_{ni,t}$.²⁵ The geography variables are obtained from CEPII.

With $\theta = 5.03$, estimated trade costs can be computed with estimates of b_1 , b_2 , and b_3 via (C.16). Then, relative technology stock $T_{i,\nu}$ can be backed out from the model structure, as in [Fielier \(2011\)](#) and [Ravikumar, Santacreu and Sposi \(2019\)](#). We interpret the observed economy as on the balanced growth path so that $M_{i,\nu} = M_i$. The technology stock $T_{i,\nu} = M_i \gamma^\nu t_{i0}$ on the BGP scales up γ times larger upon each successful innovation, but in each time point the relative technology stocks, i.e., the pair-wise ratios of $T_{i,\nu}$, remain constant. The technology stocks backed out by the following procedure are indeed relative technology stocks, since each country's technology stock T_i is unique, up to a scaling constant. With data values of M_i (see Section 5), we can then back out the relative knowledge stock parameters $t_{i,0}$.

Given $\hat{D}_i^{exp}$, $(\theta, \alpha, \tau_{n,i})$ and nominal wages w_i^{data} for each country,²⁶ we solve $\{T_i, P_i, C_i\}$

²⁵The trade flows data are obtained from the BACI data in CEPII, and the original source is UN Comtrade. Intra-national flow $X_{ii,t}$ is constructed by $X_{ii,t} = GO_{i,t} - \sum_{i \neq n} X_{in,t}$, where $GO_{i,t}$ is country i 's gross output at year t . Data on gross output is available in CEPII during 2000-2006.

²⁶We use the average values of GDP per capita in current US dollar from WDI to proxy nominal wages.

by the following system of equations

$$\begin{aligned} T_i C_i^{-\theta} &= \exp(\hat{D}_i^{exp}) \\ C_i &= (w_i^{data})^\alpha P_i^{1-\alpha} \\ P_i &= \left(\sum_{m=1}^I T_m [C_m \tau_{i,m}]^{-\theta} \right)^{-\frac{1}{\theta}}, \end{aligned}$$

where in the last equation, we have renormalized the constant in the price index $\eta = 1$ (see BEJK Result 3). This is without loss of generality as what matters for equilibrium is the relative technology stock. With data values of M_i , we then compute $t_{i0} \propto T_i/M_i$.

D Additional Tables

Table D.1: List of Countries

Country Name	iso code	Country Name	iso code
Australia	AUS	Guatemala	GTM
Belgium	BEL	Croatia	HRV
Canada	CAN	Hungary	HUN
Switzerland	CHE	India	IDN
Germany	DEU	Iran	IRN
Denmark	DNK	Iceland	ISL
Spain	ESP	Jamaica	JAM
Finland	FIN	Korea	KOR
France	FRA	Latvia	LVA
United Kingdom	GBR	Mexico	MEX
Ireland	IRL	Malaysia	MYS
Italy	ITA	New Zealand	NZL
Japan	JPN	Panama	PAN
Netherlands	NLD	Peru	PER
Norway	NOR	Poland	POL
Singapore	SGP	Portugal	PRT
Sweden	SWE	Romania	ROU
United States	USA	Russia	RUS
Argentina	ARG	Slovenia	SVN
Bosnia and Herzegovina	BIH	Thailand	THA
Brazil	BRA	Trinidad & Tobago	TTO
Chile	CHL	Turkey	TUR
China	CHN	Uganda	UGA
Colombia	COL	Uruguay	URY
Ecuador	ECU	Venezuela	VEN
Greece	GRC	South Africa	ZAF

E The Role of Intermediate Inputs

This paper incorporates intermediate inputs in the production process in a “roundabout” fashion as in [Krugman and Venables \(1995\)](#) and [Eaton and Kortum \(2002\)](#). We do not incorporate more full-fledged approaches developed in the recent trade literature to clarify the interactions among intermediate inputs, trade, and dynamics. For this purpose, we compare the benchmark results with an alternative model where there are no intermediate inputs, i.e., $\alpha = 1$. The model is recalibrated.

The results are presented in Panel B of Table [E.2](#), and Panel A replicates the benchmark result for ease of comparison. We report only the first scenario, as the pattern of larger dynamic gains in the first scenario than in the second remains. We report only the simple decomposition (hence omitting reporting the true dynamic gains) because the growth-rate gains still approximate the true dynamic gains well in this case.

Compared with the benchmark case, the ACR gains are reduced, and the growth-rate gains are increased when production does not require intermediate inputs. The increases in growth-rate gains far outweigh the reductions in ACR gains, so the total gains and the dynamic share both increase. The fact that the presence of intermediate inputs increases the ACR gains is well-understood in the literature. The ACR statistic hinges on the trade flows, and the presence of intermediates increases trade flows and the importance of trade barriers. But why do the growth-rate gains increase so much?

The answer lies in how the recalibration changes the parameters. Following the quantification procedure in Section [5](#), the recalibrated model indicates a larger technology gap between North and South countries. The average t_{i0} of the North countries is 14.7 times larger than that of the South countries in the benchmark; this ratio grows to be 87.1 in the model without intermediates. The recalibration also renders higher innovation parameters $(\kappa, \epsilon) = (7.46, 0.30)$, compared with $(2.04, 0.20)$. The higher technology gap implies a larger wage gap, which is instrumental to the dynamic gains, as illustrated in Section [3.2](#). Larger innovation parameters imply faster GPT innovation, which also contributes to larger dynamic gains.

So, we need to understand how the recalibration rationalizes the data targets. First, observe ([37–39](#)). With intermediates, the labor share $\alpha < 1$, and this allows countries to source from other countries and hence to utilize the labor forces and technology in other countries. This tends to smooth the differences in the production costs C_i . If international sourcing is shut down ($\alpha = 1$), $C_i = w_i^{data}$ and hence the differences in the production costs are enlarged. Because the wage levels in the North countries are higher than those in the South and the exporter fixed effects from the gravity-equation estimation are unaffected,

Table E.2: The Role of Intermediate Inputs

Panel A: From Autarky to Benchmark Trade Costs (with Intermediates)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	30.62	27.4	0.14	3.07
North Avg (weighted)	32.07	27.4	0.67	3.99
South Avg (weighted)	30.23	27.4	0	2.82
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	89.51		0.46	10.03
North Avg (weighted)	85.45		2.1	12.45
South Avg (weighted)	90.66		0	9.34
Panel B: From Autarky to Benchmark Trade Costs (without Intermediates)				
	Total Gains (%)	GR Gains (%)	IG Gains (%)	ACR Gains (%)
Avg (weighted)	39.9	38.12	0.07	1.71
North Avg (weighted)	40.68	38.12	0.32	2.24
South Avg (weighted)	39.69	38.12	0	1.57
	Share of GR Gains (%)		Share of IG Gains (%)	Share ACR Gains (%)
Avg (weighted)	95.55		0.17	4.29
North Avg (weighted)	93.71		0.78	5.51
South Avg (weighted)	96.05		0	3.95

the technology gap between the North and the South must become larger to rationalize the exporter fixed effects and data wages.

Second, to understand why κ and ε increase, first note that with w_ν^R normalized to 1, $P_\nu \equiv \prod_{i=1}^I P_{i,\nu}^{\mu_i}$, and (31), the R&D multiplier in (29) is proportional to $\sum_{i=1}^I X_{i,\nu+1} \times (P_\nu/P_{\nu+1}) = \sum_{i=1}^I X_{i,\nu+1} \times \gamma^{\frac{1}{\theta\alpha}}$. The presence of intermediate inputs increases gross output $\sum_{i=1}^I X_{i,\nu+1}$ and expedites the decline in the price index due to the recursive structure in the roundabout production. Thus, the presence of intermediate inputs implies a faster annual growth rate $\gamma^{\frac{\lambda(R)}{\theta\alpha}} - 1$ compared with the case without intermediates. However, to match the same annual growth rate in the data, the model without intermediate inputs must require a faster arrival rate and hence the increases in κ and ε .