

# Cattle, Steaks and Restaurants: Development Accounting when Space Matters\*

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## Abstract

We introduce location choice in a multi-sector general equilibrium model to study how it affects development accounting. Producers in agriculture, manufacturing and services choose their location to trade off land rents with transport costs to the city center. We show how space affects the aggregate production function and decompose output per worker into productivity, land per worker, and a term adjusting for sector location. In our model, services are luxury goods. As a result, richer cities have larger service cores, higher service prices, and relatively less output per worker in services. These predictions are broadly consistent with the data. We calibrate our model to data on cities in OECD countries and show that land and location explain 10–30 percentage points of the variation in output per worker.

Output per worker is much lower in poor countries than in rich ones (Klenow and Rodriguez-Clare 1997; Hall and Jones 1999; Caselli 2005). To understand the fundamental causes of productivity differences, it is important to identify the sectors in which these differences are the greatest. Several recent papers have studied the sectoral composition of productivity differences by using data on sector-level inputs, outputs and prices (Baily and Solow 2001; Caselli 2005; Restuccia, Yang, and Zhu 2008; Duarte and Restuccia 2010; Duarte and Restuccia 2015). Their main result is

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that productivity differences are sizeable and they are larger in agriculture than in manufacturing and services.<sup>1</sup>

Labor productivity depends on the quantity or quality of inputs used in the production process. Here we argue that land input has been conspicuously missing from development accounting exercises to date. Controlling for land when estimating macro productivity is important for two reasons. First, countries with high population density are relatively scarce in land and, to the extent that land matters in production, these countries will have low labor productivity. Second, land varies in a crucial quality component: its proximity to consumers. Urban land is more valuable because it is more productive in producing goods and services with high transport costs. Again, countries may differ in the availability of urban land. Accounting for land and location is especially important for sector-level development accounting. Agriculture uses land intensively and will be especially sensitive to controlling for the quantity of land. Services, in turn, locate in urban areas and will be especially sensitive to controlling for location.

To understand how land and location affect development accounting, we build a simple multi-sector general equilibrium model. Each sector uses labor (or a composite of other spatially mobile inputs) and land. The location of sectors is determined as in the canonical von Thünen city model. In the model, all trade happens in the city center, the central business district (CBD). Producers choose their location freely on a plane, and have to pay a shipping cost to transport their goods to the CBD. This spatial structure introduces variable land-quality to the model, as land closer to the CBD saves on transport cost. Equilibrium rents decrease with distance from the CBD, and the producers optimally choose locations to balance savings on transport costs with higher rents. Our model yields a simple spatial equilibrium in which agriculture (“cattle”) locates farthest away from the center, manufacturing (“steaks”) occupies a ring outside the center, and services (“restaurants”) are in a central circle.

We can decompose output per worker into three components: (i) Hicks neutral productivity (which will also capture the presence of spatially mobile factors such as capital), (ii) land per worker, and (iii) a term reflecting distance to consumers. Components (ii) and (iii) are novel to our model. First, as some sectors are more land intensive, their labor productivity will be more sensitive to the scarcity or abundance of land. Conditional on other productivity factors, agricultural output per worker will be higher in countries with an abundant supply of land. Second, urban sectors

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<sup>1</sup>These results are in line with the classic Balassa-Samuelson literature (Balassa 1964; Samuelson 1964; Baumol and Bowen 1965; Baumol 1967), which explains sectoral price-level differences by productivity advantage of manufacturing over services.

(such as services) will be relatively more productive in smaller cities where transport costs are lower.

To quantify the importance of these two mechanisms, we calibrate our model to city-level data on employment density, city size, and GDP per capita (from the OECD Metropolitan Areas Database) and country-level prices and expenditure shares (from the International Comparison Program). We set common technology parameters to match the sectoral land-shares and spatial distribution of economic activities in the U.S. We then use the calibrated model to decompose output per worker into the three components for each city.

Perhaps unsurprisingly, the largest variation across cities in output per worker is due to variation in Hicks neutral productivity. We estimate this productivity variation to be essentially the same in the three broad sectors. This is in contrast with the existing literature, which finds more variation agricultural productivity (Caselli 2005; Restuccia, Yang, and Zhu 2008),<sup>2</sup> and less variation in services productivity (Balassa 1964; Samuelson 1964; Herrendorf and Valentinyi 2012).<sup>3</sup>

Variation in land per worker explains up to 30 percentage points of productivity differences across the cities in our sample. This variation is biggest in agriculture, which uses land intensively. In our sample, land per worker does not vary systematically with development.

Sector location explains up to 10 percentage points of productivity differences. This varies systematically with development as poorer cities spend less on services and have smaller service cores. Transportation costs in these cities is lower and output per worker is higher.

More broadly, our model illustrates how to incorporate space in a simple development accounting model and that transport costs can have macro relevance. In related work, Ramondo, Rodríguez-Clare, and Saborío-Rodríguez (2016) incorporate space in a macro model with transport costs, arguing that large countries have larger transport costs and hence not as high GDP per capita. The main difference is that while Ramondo, Rodríguez-Clare, and Saborío-Rodríguez (2016) capture average trade costs across cities within a country, our main focus is the within-city trade cost and spatial structure. Also related are Desmet and Rossi-Hansberg (2013), who study an endogenous system of cities (in our work, cities are exogenous in size) and Desmet and Rossi-Hansberg (2014), who study cities and growth (our model is static). Neither of

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<sup>2</sup>Admittedly, data on metropolitan areas is less informative about productivity in agriculture than in the two other sectors.

<sup>3</sup>Duarte and Restuccia (2015) find that productivity in tradable business services varies more than in manufacturing.

these papers focus on the spatial allocation of sectors as we do. Adamopoulos (2011) analyzes the impact of lower transport costs in rich countries on their productivity advantage. He finds that lower transport costs can reduce missallocation, improve agriculture productivity and lead to the reallocation of labor away from agriculture.<sup>4</sup> Differently from him, our focus is on the heterogeneity in transport cost across sectors and its impact on structural transformation and urbanization.

Lagakos and Waugh (2013) study a model of structural change where workers vary in agricultural productivity. In poor countries, more people will work in agriculture, and their average productivity will be low. Our model features a similar mechanism, but in our setting, it is the productivity of land that is heterogeneous, as it depends on distance to the center. In rich countries, more land will be devoted to services, resulting in relatively lower output per worker.

Heterogeneous land quality contributes also to the reallocation of labor towards urban sectors, usually referred to as structural transformation (for a recent review, see Herrendorf, Rogerson, and Valentinyi (2014)). Development increases the relative demand for the more luxury urban goods (Echevarria 1997; Kongsamut, Rebelo, and Xie 2001; Gollin, Parente, and Rogerson 2002). This increases the scarcity of urban land, and forces urban sectors to substitute towards labor. Furthermore, the increasing price of urban land raises the relative price of urban sectors, and modifies the measurement of relative technological growth. Our estimation suggests that technology grows relatively faster in rural sectors (Ngai and Pissarides 2007a; Restuccia, Yang, and Zhu 2008), and this exerts an additional force towards structural transformation [FIXIT: does it?].

Our model is motivated by four robust empirical facts. First, urban land becomes more important with development relative to rural land (Clark 2007, Figure 10.3). Second, the relative price of services increase with development. This is known as Baumol’s cost disease (Baumol and Bowen 1965) or the Balassa-Samuelson effect (Balassa 1964; Samuelson 1964). Third, rich countries are more urbanized (United Nations 2014). Fourth, rich countries produce less agriculture and more services (Kuznets 1973; Ngai and Pissarides 2007b; Kongsamut, Rebelo, and Xie 2001). As we show below, our model is capable of explaining these facts in a simple framework.

## 1 A model of industry location

We introduce location choice to a multi-sector general equilibrium model. We have three sectors: agriculture, manufacturing and services, each using land and labor for

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<sup>4</sup>See also Gollin and Rogerson (2014, Adamopoulos and Restuccia (2014).

production. Our spatial structure follows the von Thünen monocentric city model: producers choose a location on the plane and need to transport their goods to the central business district.

A city is a point on a bounded but otherwise featureless two-dimensional plane. A country is a collection multiple cities, with some goods and people moving freely across these cities. We assume that countries are large enough such that city boundaries never overlap with each other or with country boundaries.

We first characterize the distribution of economic activities within a city, then discuss equilibrium allocation across cities within a country.

## 1.1 Consumers

To be consistent with Fact 4, we assume non-homothetic consumer preferences. We follow Fieler (2011) in assuming an isoelastic utility function with different elasticities for the three sectors.<sup>5</sup>

A consumer living in city  $c$  enjoys utility

$$u_c = \alpha_u^{1/\sigma_u} \frac{\sigma_u}{\sigma_u - 1} C_{cu}^{1-1/\sigma_u} + \alpha_r^{1/\sigma_r} \frac{\sigma_r}{\sigma_r - 1} C_{cr}^{1-1/\sigma_r}, \quad (1)$$

where  $\alpha_i > 0$  is the weight of sector  $i$  and  $\sigma_i > 1$  governs the sector's price and income elasticity. Sector  $u$  refers to “urban goods,”  $r$  refers to “rural goods.”

There is a mass  $N$  of consumers who supply one unit of labor inelastically, and rent land to producers in a competitive market. They are *absentee landlords*: the rents they collect are independent of the place of employment.

The budget constraint of a city- $c$  consumer is

$$P_u C_u + P_r C_r = W_c + R/N, \quad (2)$$

where  $W_c$  is the wage level in city  $c$  and  $R$  is the total rent in the economy.

The sectoral consumption expenditures satisfy

$$P_i c_i = \alpha_i \lambda^{-\sigma_i} P_i^{1-\sigma_i}, \quad (3)$$

where  $\lambda$  is the Lagrange multiplier of the budget constraint, which is decreasing in income. For a given set of prices, the expenditure of good  $u$  relative to good  $r$  is increasing in income if  $\sigma_u > \sigma_r$ . The income elasticity of good  $i$  is

$$\frac{\partial \ln c_i}{\partial \ln y} = \frac{\sigma_i}{\sum_j x_j \sigma_j}, \quad (4)$$

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<sup>5</sup>We have estimated the preferences proposed by Kongsamut, Rebelo, and Xie (2001), Ngai and Pissarides (2007b) and Herrendorf, Rogerson, and Valentinyi (2013) on cross-country data, but this provided a poor fit for rich countries, where the role of necessity spending is vanishingly small.

where  $x_j = P_j c_j / \sum_k P_k c_k$  is the expenditure share of good  $j$ .

## 1.2 Producers

Output in sector  $i$  at location  $z$  depends on labor  $N$  and land  $L$  used at that location,

$$Q_i(z) = \beta^{-\beta} (1 - \beta)^{-(1-\beta)} A_i L_i(z)^\beta N_i(z)^{1-\beta}.$$

We take labor to be freely mobile within the city, land is in fixed  $\bar{L}(z)$  supply in each location. The names “land” and “labor” are for the sake of convenience, these two factors correspond to spatially fixed and mobile factors, respectively, and we will calibrate them accordingly.<sup>6</sup>

Products are sold at a single marketplace in each city, the central business district. This is location  $z = 0$ , so that  $z$  indexes distance to the center. We will first characterize the spatial equilibrium in one city, then discuss the equilibrium across multiple cities within a country.

There are two sectors, urban and rural. The urban sector has a shipping cost, rural sector does not. To ship an urban product to the center, one has to incur shipping costs. If a unit of product leaves location  $z$ , only

$$e^{-\tau z}$$

units arrive at the center. This is akin to the iceberg assumption of transport costs.

In the rural sector, goods can be shipped freely. This will ensure that in equilibrium agricultural goods are produced outside cities in rural areas.

Profits from production at  $z$  are

$$\Pi_u(z) = P_u e^{-\tau z} Q_u(z) - W_u N_u(z) - R_u(z) L_u(z) \quad (5)$$

for the urban sector and

$$\Pi_r(z) = P_r Q_r(z) - W_r N_r(z) - R_r L_r(z) \quad (6)$$

for the rural sector. A sector being active at location  $z$  requires that their maximized profit  $\max \Pi(z) \geq 0$ .

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<sup>6</sup>For analytical convenience, we assume that both sectors have the same land intensity  $\beta$ . This will ensure that the overall national wage level does not affect city size. In practice, rural sector have a somewhat higher land intensity. The qualitative conclusions of our model are the same in this case.

### 1.3 Spatial Sorting

Because space is featureless, the available land at each distance  $z$  from the CBD is  $\bar{L}(z) \equiv 2z\pi$ . We study symmetric equilibria where the distance to the CBD completely characterizes a location.

**Definition 1.** *Given a level of rural prices  $P_r$  and wages  $W_u, W_r$ , define the spatial sorting in a circular city as a set of quantities  $Q_i(z), L_i(z), N_i(z)$  and prices  $P_u, R(z)$  such that*

1. *The producers choose location  $z$ , and nonnegative quantities  $Q_i(z), L_i(z), N_i(z)$  to maximize their profits (5), taking prices as given.*
2. *Land markets clear at every location:  $L_u(z) + L_r(z) = \bar{L}(z)$  for all  $z \in Z$ .*

The spatial sorting, as we show below, has a simple and intuitive structure. The urban sector with a positive transport cost intensity  $\tau$  locates closer to the center. The rural sector is produced outside cities.

To see why this is the case, construct the sectoral bid rent curve  $R_i(z)$ . This is the maximum rent an active producer in the urban sector would be willing to pay at location  $z$ . A profit maximizing producer is choosing its land  $L_i(z)$  and labor demand  $N_i(z)$  to equalize the value marginal product of land and labor to rents and wages, respectively. It is true for any rent function or wages it might face, so it is true for rents given by its own bid-rent curve  $R_i(z)$ , in particular.

$$R_i(z) = \beta^{1-\beta}(1-\beta)^{-(1-\beta)} P_i e^{-\tau_i z} A_i \left( \frac{N_i(z)}{L_i(z)} \right)^{1-\beta} \quad (7)$$

$$W = \beta^{-\beta}(1-\beta)^\beta P_i e^{-\tau_i z} A_i \left( \frac{N_i(z)}{L_i(z)} \right)^{-\beta} \quad (8)$$

The sectoral labor-land ratio (employment density) can be expressed as

$$\frac{N_i(z)}{L_i(z)} = \frac{1-\beta}{\beta} \frac{R_i(z)}{W}. \quad (9)$$

Substituting this into the first-order condition for land use and rearranging, we get the bid rent curve of the urban sector:

$$R_i(z) = (P_i A_i)^{1/\beta} W^{1-1/\beta} e^{-\frac{\tau_i}{\beta} z} \quad (10)$$

with  $\tau_u = \tau$  for the urban sector and  $\tau_r = 0$  for the rural sector. Equation (10) pins down the gradient of the sectoral rent curve, which determines how fast the bid-rents

decrease with the distance from the CBD. The gradient is an increasing function of the transport cost and a decreasing function of land share  $|\partial \log R(z)/\partial \log z| = \tau/\beta$ . Intuitively, transport costs ( $\tau z$ ) increase with distance, so producers offer lower rents for farther locations. If land were the only factor of production ( $\beta = 1$ ), only this direct effect would be present and the gradient would only depend on the transport cost intensity. With labor present, however, the producers can substitute labor for land, introducing an indirect effect on the gradient. As the equilibrium land-labor ratio shows (see equation 9), the land share  $\beta$  determines the strength of this substitutability: higher land share implies bid-rent curves decreasing with a slower rate.

Wherever the rural sector is active, it pays a fixed rent of

$$R_r = (P_r A_r)^{1/\beta} W^{1-1/\beta}$$

Because agricultural goods are freely tradable, their bid-rent does not depend on location.

We can also get the urban employment gradient by substituting the bid rent curve into the labor-land ratio,

$$\frac{N_u(z)}{L_u(z)} = \frac{1-\beta}{\beta} \left( \frac{P_u A_u}{W} \right)^{1/\beta} e^{-\frac{\tau}{\beta} z}. \quad (11)$$

This is the relationship we use to calibrate the sectoral transport cost intensities.

**Proposition 1.** *There exists a competitive spatial equilibrium, characterized by location  $0 < z_u$  such that the urban sector produces at  $[0, z_u]$ , and agriculture locates in  $(z_u, \infty)$ .*

The proof is provided in the Appendix. Intuitively, the different exponential slope of the bid-rent curves ensures that they cross exactly once. This results in a strict partitioning across sectors, as shown in Figure 1.

Each city is characterized by a distance cutoff  $z_u$ . Locations  $z > z_u$  cannot be associated with any particular city and we will call them agricultural or rural land. This implies that  $z_u$  will be the functional city boundary and we will calibrate the model accordingly.

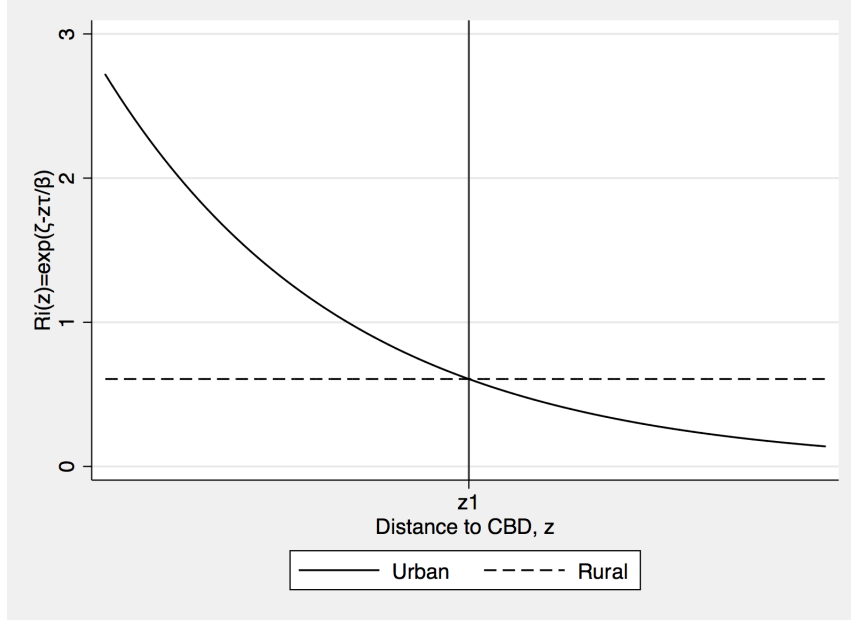
## 1.4 Aggregation across space

For the urban sector, production is a function of a suitably chosen representative location. Sectoral output measured at the center is

$$\tilde{Q}_u = B \int_{z=0}^{z_u} e^{-\tau z} A_u L(z)^\beta N_u(z)^{1-\beta} dz,$$



Figure 1: Spatial equilibrium



The figure plots the structure of a competitive spatial equilibrium. It shows equilibrium sectoral bid rent curves as a function of distance from the city center. A sector is active over an area where it is willing to overbid the sector. Crossings of the bid-rent curves determine the borders of the sectors. The urban sector is active in  $[0, z_u]$ , agriculture in  $(z_u, \infty)$ .

with  $B = \beta^{-\beta}(1 - \beta)^{-(1-\beta)}$ .

Let the representative location

$$\tilde{z} = -\frac{\beta}{\tau} \ln \int_{z=0}^{z_u} \frac{L(z)}{L_u} e^{-\frac{\tau}{\beta} z} dz \quad (12)$$

denote the average distance of the urban sector to the center, where  $L_u = \int_{z=0}^{z_u} L(z) dz$  is the total amount of land devoted within the city fringe. This definition ensures that the trade cost going to location  $\tilde{z}$  equals the land-weighted average trade cost across all sectoral locations,

$$e^{-\frac{\tau}{\beta} \tilde{z}} = \int_{z=0}^{z_u} \frac{L(z)}{L_u} e^{-\frac{\tau}{\beta} z} dz.$$

As we will see below,  $\tilde{z}$  is a sufficient statistic about sector location for aggregation purposes.

**Proposition 2.** *City-level sectoral production function is of the form:*

$$\tilde{Q}_u = B A_u L_u^\beta N_u^{1-\beta} e^{-\tau \tilde{z}}. \quad (13)$$

It depends on trade costs from the representative location ( $\tilde{z}$ ) defined by equation (12) and is a Cobb-Douglas aggregate of sectoral land ( $L_u = \int_{z=0}^{z_u} L(z)dz$ ) and labor ( $N_u = \int_{z=0}^{z_u} N(z)dz$ ) use.

Rent arbitrage between manufacturing and agriculture,  $R_u(z_u) = R_r$ , pins down the city boundary:

$$e^{z_u \tau} = \frac{P_u A_u}{R_r^\beta W^{1-\beta}} = \frac{P_u A_u}{P_r A_r} \quad (14)$$

The size of the city increases in the relative price and relative productivity of urban goods. Intuitively, when cities are productive (either in price or quantity), they can outbid the rural sector for land. These cities will be larger.

City employment density is

$$\frac{N_u}{L_u} = \frac{1-\beta}{\beta} \left( \frac{P_u A_u}{W} \right)^{1/\beta} e^{-\tilde{z}\tau/\beta} = \frac{1-\beta}{\beta} \left( \frac{P_u A_u}{P_r A_r} \right)^{1/\beta} \left( \frac{W}{P_r A_r} \right)^{-1/\beta} e^{-\tilde{z}\tau/\beta}. \quad (15)$$

For a given city area, employment is increasing in the relative price and relative productivity of the city and decreases in the wage rate. It also decreases in city size. More productive cities will pay higher average rent, so producers will substitute land for labor. The opposite will hold when wages are high. And city size decreases employment density because of a selection effect: the the typical plot of land in large cities will be cheaper land, far away from the center. These plots will make more intense use of land.

Equations (14) and (15) completely characterize the spatial sorting within a city. City features depend on relative urban to rural productivity and a relative wage rate.

The primary object of interest is the rent curve plotted in Figure 1. Urban rents will be always higher than rural rents, because urban plots have a productivity advantage: they are closer to the center. Even though city boundaries are determined in frictionless equilibrium, rents are only equalized *at the margin*. Rents at infra-marginal urban locations command a premium. More specifically, the ratio of urban to rural rent

$$\frac{R_u}{R_r} = \frac{R(0)e^{-\tilde{z}\tau/\beta}}{R_r},$$

and, given that  $R(z_u) = R_r$ ,

$$\frac{R_u}{R_r} = e^{(z_u - \tilde{z})\tau/\beta} > 1. \quad (16)$$

The urban rent premium in (16) will serve a crucial role in characterizing the aggregate economy of multiple cities.

## 1.5 Multi-city equilibrium

The above equations characterize production in a city conditional on product prices and wages. These, in turn, are pinned down in a multicity equilibrium. The spatial sorting pins down the supply of urban sectors. We assume that both urban and rural goods are tradable freely within the country. That is, at the marketplace, the goods produced at other cities are freely available so that the law of one price holds across cities.<sup>7</sup>

Cities differ in productivity of the urban good  $A_c$ .

**Definition 2.** *The multi-city equilibrium of a country is a collection of spatial sortings for each city, a set of prices  $P_u$ ,  $P_r$  and wages  $W$  such that*

1. *Consumers maximize utility (1) subject to their budget constraint (2), taking prices as given.*
2. *Goods markets clear at the country level:  $\sum_{c=1}^K N_c C_{ic} = \sum_{c=1}^K \tilde{Q}_{ic}$ .*
3. *Utility is equalized across cities.*
4. *Labor market clears at the country level:  $\sum_{c=1}^K N_c = N$ .*

[FIXME: Prove existence.]

Take the conditions for spatial sorting (14) and (15). Introduce the subscript  $c$  for cities. Utility equalization implies wages are the same in each city as well as rural areas.

The conditions for competitive spatial equilibrium are

$$e^{z_c \tau} = \frac{P_u A_c}{P_r A_r} \tag{i}$$

$$N_c = L_c \frac{1-\beta}{\beta} \left( \frac{P_u A_c}{P_r A_r} \right)^{1/\beta} \left( \frac{W}{P_r A_r} \right)^{-1/\beta} e^{-\tilde{z}_c \tau / \beta}$$

$$N_c = \frac{1-\beta}{\beta} \left( \frac{W}{P_r A_r} \right)^{-1/\beta} e^{(z_c - \tilde{z}_c) \tau / \beta} L_c$$

Adding up labor demand across cities,

$$N_u = \sum_c N_c = \frac{1-\beta}{\beta} \left( \frac{W}{P_r A_r} \right)^{-1/\beta} \sum_c e^{(z_c - \tilde{z}_c) \tau / \beta} L_c.$$

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<sup>7</sup>We assume away frictions across cities to focus on the urban-rural divide and to present closed-form characterizations of the aggregate economy. We leave extensions of the model to city-to-city iceberg trade costs for future work.

Rural labor demand is

$$N_r = \frac{1-\beta}{\beta} \left( \frac{W}{P_r A_r} \right)^{-1/\beta} L_r.$$

Using labor market clearing  $N = N_u + N_r$ , we can solve for the relative wage.

$$\left( \frac{W}{P_r A_r} \right)^{1/\beta} = \frac{1}{N} \frac{1-\beta}{\beta} \left[ L_r + \sum_c e^{(z_c - \bar{z}_c)\tau/\beta} L_c \right].$$

Introduce the notation

$$\bar{L}_u \equiv \sum_c e^{(z_c - \bar{z}_c)\tau/\beta} L_c$$

for the rent-corrected total quantity of urban land and  $\bar{L} = L_r + \bar{L}_u$ . Recall that city- $c$  has a rent premium  $e^{(z_c - \bar{z}_c)\tau/\beta}$  over rural land. This is also a population-density corrected amount of land: the amount of land that would be needed to host all the population of the country, were its density constant at the rural population density.

$$\bar{L} = L_r \frac{N/L}{N_r/L_r}.$$

This permits us to write the relative rural wage as

$$\frac{W}{P_r A_r} = \frac{(1-\beta)^\beta}{\beta^\beta} \left( \frac{\bar{L}}{N} \right)^\beta$$

Substituting in for city employment,

$$N_c = N \frac{e^{(z_c - \bar{z}_c)\tau/\beta} L_c}{\bar{L}} \quad (\text{ii})$$

Equations (i) and (ii) completely characterize the production side of the economy for given relative prices  $P_u/P_r$ . To close the model with the demand side, we express urban and rural output and solve for relative price as the relative marginal utility.

Output of the rural good

$$Q_r = B A_r L_r^\beta N_r^{1-\beta} = B A_r N (\bar{L}/N)^\beta \frac{L_r}{\bar{L}}$$

Rural production (and consumption) per capita,

$$C_r = \frac{Q_r}{N} = B A_r \left( \frac{\bar{L}}{N} \right)^\beta \frac{L_r}{\bar{L}}. \quad (17)$$

Output increases in rural productivity and the availability of effective land per worker. It also increases in the share of effective land devoted to rural production.

Output of the urban good is

$$Q_u = \sum_c Q_c = BA_r \frac{P_r}{P_u} \left( \frac{N}{\bar{L}} \right)^{1-\beta} \sum_c e^{(z_c - \bar{z}_c)\tau/\beta} L_c.$$

$$Q_u = BA_r \frac{P_r}{P_u} \left( \frac{N}{\bar{L}} \right)^{1-\beta} \bar{L}_u.$$

Urban production and consumption per capita is

$$C_u = \frac{Q_u}{N} = BA_r \left( \frac{\bar{L}}{N} \right)^\beta \frac{P_r}{P_u} \frac{\bar{L}_u}{\bar{L}}. \quad (18)$$

Output increases in rural productivity and the availability of effective land per worker. Notice that it is the rural productivity that shifts output. The relative productivity of the urban sector enter through the effective quantity of land. Urban output decreases in urban relative price. This is a correction for the effective land measure: if the rent premium of urban rent also captures the relative price of urban products and we have to correct for this to capture productivity. Naturally, the quantity of land devoted to cities also increases urban output per capita.

Let  $\zeta = BA_r N^{-\beta} \bar{L}^{\beta-1}$  denote the common supply shifter of urban and rural output. Intuitively, whenever  $\zeta$  is higher, consumers are richer.

Plug in (17) and (18) into the demand equations (3) and take the ratio to get rid of the Lagrange multiplier  $\lambda$ .

$$\frac{\alpha_u^{1/\sigma_u}}{\alpha_r^{1/\sigma_r}} \zeta^{1/\sigma_r - 1/\sigma_u} \frac{\bar{L}_u^{-1/\sigma_u}}{L_r^{-1/\sigma_r}} \left( \frac{P_u}{P_r} \right)^{1/\sigma_u} = \frac{P_u}{P_r}$$

Rearranging,

$$\frac{\bar{L}_u^{1/\sigma_u}}{L_r^{1/\sigma_r}} = \frac{\alpha_u^{1/\sigma_u}}{\alpha_r^{1/\sigma_r}} \zeta^{1/\sigma_r - 1/\sigma_u} \left( \frac{P_u}{P_r} \right)^{1/\sigma_u - 1}.$$

$$\frac{\bar{L}_u}{L_r} = L_r^{1-\sigma_u/\sigma_r} \frac{\alpha_u}{\alpha_r^{\sigma_u/\sigma_r}} \zeta^{\sigma_u/\sigma_r - 1} \left( \frac{P_u}{P_r} \right)^{1-\sigma_u}.$$

Expressing  $P_u/P_r$ ,

$$\frac{P_u}{P_r} = \zeta^{(\sigma_u/\sigma_r - 1)/(\sigma_u - 1)} \frac{(\bar{L}_u/\alpha_u)^{-1/(\sigma_u - 1)}}{(L_r/\alpha_r)^{-\sigma_u/\sigma_r(\sigma_u - 1)}} \quad (\text{iii})$$

For given land allocation, this is increasing in consumer wealth  $\zeta$ , because  $\sigma_u > \sigma_r > 1$ . Equations (i), (ii) and (iii) fully characterize the multi-city equilibrium.

Assuming that taste shocks are uncorrelated with productivity shocks, we can estimate  $\sigma$ s by a simple IV.

We add urban and rural output to obtain a fixed-price GDP,

$$Y \equiv P_{r0}Q_r + P_{u0}Q_u = BA_rP_{r0} \left( \frac{N}{\bar{L}} \right)^{1-\beta} \left[ L_r + \frac{P_r/P_{r0}}{P_u/P_{u0}} \bar{L}_u \right]. \quad (19)$$

$$Y = BA_rP_{r0} \left( \frac{N_r}{\bar{L}_r} \right)^{1-\beta} L_r \left[ 1 + \frac{P_r/P_{r0}}{P_u/P_{u0}} \frac{\bar{L}_u}{\bar{L}_r} \right].$$

Real GDP increases in rural productivity, rural population density ...

$$\frac{P_r}{P_u} = \zeta^{(1-\sigma_u/\sigma_r)/(\sigma_u-1)} \frac{(\bar{L}_u/\alpha_u)^{1/(\sigma_u-1)}}{(L_r/\alpha_r)^{\sigma_u/\sigma_r(\sigma_u-1)}}$$

$$\frac{P_r \bar{L}_u}{P_u L_r} = \zeta^{(1-\sigma_u/\sigma_r)/(\sigma_u-1)} \frac{\alpha_u^{-1/(\sigma_u-1)} \bar{L}_u^{\sigma_u/(\sigma_u-1)}}{\alpha_r^{-\sigma_u/\sigma_r(\sigma_u-1)} L_r^{1+\sigma_u/\sigma_r(\sigma_u-1)}}$$

## 1.6 Space and development

The following propositions characterize how space use depends on development.

**Proposition 3** (Balanced growth). *Assume  $\sigma_u = \sigma_r$ . Then a uniform increase in productivity across sectors leaves sectoral and spatial allocations ( $z_c$ ,  $L_c$ ,  $Q_u/Q_r$ ) unchanged.*

**Proposition 4** (Structural change). *Assume  $\sigma_u > \sigma_r$ . Then a uniform increase in productivity across sectors expands the amount of land devoted to the urban sector and shrinks the amount of land devoted to the rural sector. The share of urban population goes up. The price of the urban good increases relative to the rural good.*

Proposition 4 is consistent with the empirical facts about structural change, urbanization, and the relative price of services.

**Proposition 5** (Increased demand for urban goods). *Assume  $\sigma_u > \sigma_r$ . An increase in the demand for urban goods  $\alpha_u$  increases the size of cities (both area and employment), the relative price of urban goods, and the rural real wage. [QUESTION: Does fixed-price GDP go up?]*

**Proposition 6** (Urbanization). *Assume  $\sigma_u > \sigma_r$ . Adding a new city with  $A_c > 0$  and  $\gamma_c > 0$  or increasing the productivity or amenity of any given city results in*

1. ???

## 2 Mapping the model to data

We calibrate the model to city-level data from the OECD to show how land usage and sector location varies with development. We fix a number of parameters across cities, but the supply of land and labor, as well as sectoral productivity are allowed to vary.

We assume that cities are in autarky so that we can analyze them separately.<sup>8</sup> First we calibrate land shares and shipping costs using US data. Then we turn to the calibration of parameters influencing cross-country, cross-city variations.

### 2.1 Common parameters

**Land shares.** [FIXME: Remove agriculture from this section.]

We calibrate sectoral land share ( $\beta$ ) using US data. Our aim is to capture the share of immobile factors in production. These come from two sources: (i) the direct use of land in production and (ii) the land-rent paid by workers. We calibrate the direct use of land in sectoral production using US factor income share estimates of Valentinyi and Herrendorf (2008). The first two columns of Table 1 show their estimates for land and labor shares across sectors.

The indirect use of land is the land used by workers. We calibrate land-rent share in labor as a product of the US aggregate rent-share in consumption expenditure reported by the BLS (30%) and the average land-share of US house prices between 1984-1998 estimated by Davis and Palumbo (2008) (36%). We find it to be 10.8%. We multiply this by the labor shares to get the indirect land shares listed in column 3 of Table 1. Our calibrated overall land shares ( $\beta$ ) are the sum of the direct and indirect land shares, and they are shown in column 4.

The calibrated values show that land is a non-negligible factor in production in each sectors. As expected, its role is the largest in agriculture (23%), but the land share in manufacturing and services are both double-digit (10%–13%), mainly because of the indirect land use of their workers.

[FIXME: Average land shares across urban sectors.]

**Shipping costs.** We use the 2010 ZIP Business Patterns of the U.S. Census (U.S. Bureau of the Census 2010) to determine the location of sectors in the United States. We use this to calibrate transportation costs and distances of the sectors from the center.

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<sup>8</sup>Desmet and Rossi-Hansberg (2013) study a system of cities with endogenous mobility among them.

Table 1: Calibrated factor shares

Factor shares	Direct land	Labor	Indirect land	Overall land share
Agriculture	0.18	0.46	0.05	0.23
Manufacturing	0.03	0.67	0.07	0.10
Services	0.06	0.66	0.07	0.13

Land and Labor shares are estimates of Valentinyi and Herrendorf (2008). Land share in labor is the product of rent-share in US consumption expenditures, the average land-share of US house prices between 1984-1998 estimated by Davis and Palumbo (2008) and the labor shares. Our land share estimates are the sum of direct land share and the indirect land share in labor.

The ZIP Business Patterns contains the number of establishments in employment size categories in each ZIP code for each 6-digit NAICS code. We merge NAICS codes into agriculture, manufacturing and services as follows. Agriculture is sector 11 of NAICS. We merge mining (21), utilities (22), and construction (23) together with manufacturing industries (31-33). As services, we categorize the rest, including public administration. We estimate employment by using the midpoints of the size categories.

To map the model into the data, we need to specify how far each ZIP code is from the city center. We take Urbanized Areas (UAs) as independent monocentric cities, and we assign the central point to the business or administrative center of the first-mentioned city in the UA, as given by Yahoo Maps. For example, the center of “New York–Newark, NY-NJ-CT Urbanized Area” is the corner of Broadway and Chamber St in downtown Manhattan, whereas the center of “Boston, MA–NH-RI Urbanized Area” is 1 Boston Pl. We calculate the distance of each ZIP code to business center of the nearest UA.

According to equation 9, the employment density of sector  $i$  in location  $z$  is proportional to the rent-wage ratio. When industry  $i$  demands positive land in the neighborhood of  $z$ , then the rent is proportional to  $e^{-\tau_i/\beta z}$ . We can use this observation to estimate  $\tau_i$ :

$$\frac{d \ln n_i(z)/l_i(z)}{dz} = \frac{d \ln r_i(z)}{dz} = -\frac{\tau_i}{\beta}.$$

To get a sense where each sectors is active, we calculate location quotients by distance to the city center. For each sector, they measure the employment share at a certain distance relative to the average employment share of the same sector. A value higher than 1 implies that the sector is overrepresented in the particular distance from the center.



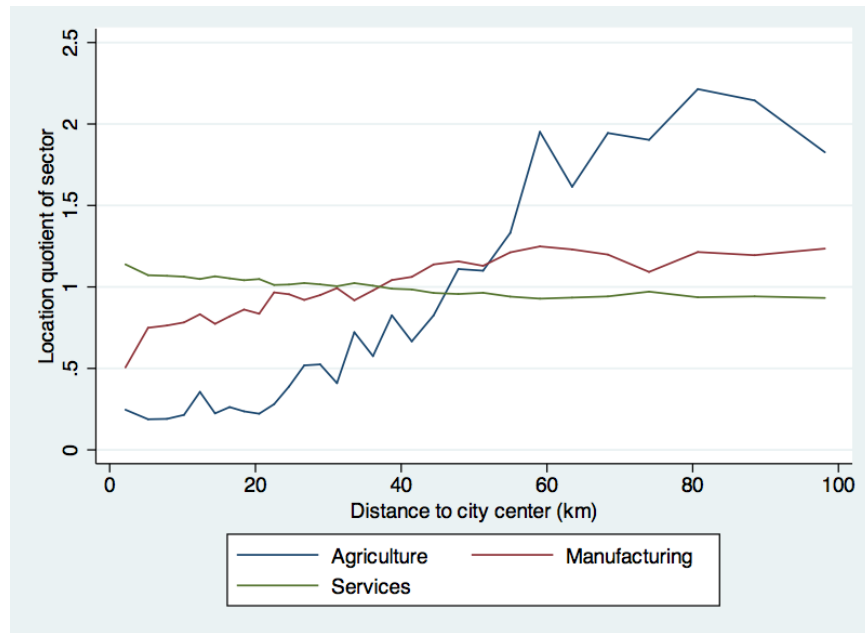


Figure 2: Sector location quotients

Source: ZIP Business Patterns. Plots the sectoral employment shares at a particular distance (in a 3km-wide ring) from the city center, relative to the average sectoral employment share. The figure shows that sectors sort as in the model: services are overrepresented closer to the city center, while manufacturing and agriculture are located mostly farther away, agriculture showing a particularly steep gradient.

Figure 2 shows that sectors sort as in the model: services are overrepresented closer to the city center, while manufacturing and agriculture are both underrepresented there. Agriculture shows a particularly steep gradient, with high relative employment farther away from the city center. In the calculation of sectoral employment gradients below, we restrict attention to the areas where the sectors are overrepresented. We assume that services are active up to 30 kms from the center, manufacturing is active between 10 and 60 kms (there is some mixed use) and agriculture farther than 60 kms.

Let  $n_{izc}$  be the employment of industry  $i$  in ZIP code  $z$ , belonging to city (MSA)  $c$ . Assuming that establishments in a given sector consume the same amount of land,<sup>9</sup> we denote by  $l_{izc}$  the number of establishments of sector  $i$  in ZIP code  $z$ . We can then regress establishment size (workers per establishment) in each sector in each ZIP code on fixed effects, and the distance of the ZIP code to the city center,

$$\frac{n_{izc}}{l_{izc}} = e^{\mu_c + \nu_i - \gamma_i d(z,c)}. \quad (20)$$

The city fixed effect captures variation in rents and wages in the MSA, the sector fixed effect captures variation in land and labor intensity and establishment size across sectors. The key parameter of interest is  $\gamma_i$ , which captures how fast employment declines with distance to the center by sector.

From the ZBP, we have the approximate employment of the sector (reconstructed from establishment-size bins), and the total area of the ZIP code, but area is not broken down by sector. If a ZIP code is exclusively used by one of the three sector, this is not a problem. Otherwise, we impute the area used by sector  $i$  as follows.

The mode predicts the area per worker in sector  $i$  in ZIP-code  $z$  to be

$$\frac{L_i(z)}{N_i(z)} = \frac{1 - \beta}{\beta} \frac{W}{R(z)}.$$

Because all sectors face the same wages and rents in the same ZIP code, we can distribute land in proportion to

$$\frac{1 - \beta}{\beta} N_i(z).$$

In urban ZIP codes, there is also a substantial amount of residential land. We know that households spend  $0.3 \times 0.36$  fraction of their income on residential land rent. Assuming that residents' only income are wages,

$$\frac{R(z)H(z)}{WP(z)} = 0.3 \times 0.36,$$

---

<sup>9</sup>We believe this approximation is likely to bias our estimates of the rent gradient downward. Rural establishments probably occupy more space than urban establishments even in the same narrow industry, so establishment sizes do not go down as fast with distance as employment density does.

where  $P(z)$  is the number of people living in ZIP code  $z$ . Hence total residential area is

$$H(z) = 0.3 \cdot 0.36P(z) \frac{W}{R(z)}.$$

We then allocate residential land in proportion to  $0.3 \cdot 0.36P(z)$ .

We estimate (20) by a Poisson regression which ensures that the equation holds in expectation, and permits estimation even when  $n_{izc} = 0$ , which is often the case. The estimates of  $\gamma_i$  and the implied sectoral transport cost intensities  $\tau_i$  in the three sectors are below.

Table 2: Estimated rent and price gradients

		<b>Gradient (per km)</b>	
	<b>Land share <math>\beta</math></b>	<b>Rents <math>\gamma_i</math></b>	<b>Prices <math>\tau_i</math></b>
Services	13%	13.15%	1.71%
Manufacturing	10%	5.15%	0.52%
Agriculture	23%	3.54%	0.81%

Sectoral rent gradients  $\gamma_i$  are estimated using US employment-density observation across ZIP codes in MSAs. Price gradients reflect transport costs ( $\tau_i$ ) and are estimated by multiplying rent gradients with sectoral land shares ( $\beta$ ).

[FIXME: Recalculate taus for common land shares.]

The three columns report the calibrated land shares, and the estimates for rent and price gradients, respectively, for each sector. The estimated coefficients can be interpreted as follows. We find that the rents paid by services become 13.15% cheaper with every kilometer from the city center over the 0-30km range, where services are active. Though a 13% reduction is substantial, it does not seem unrealistic with a whole 1 kilometer distance. In line with our intuition, rent gradients of manufacturing and agriculture (measured further away from the city center) both imply slower rent declines. We infer price gradients reflecting the transportation cost intensities ( $\tau_i$ ) from the measured rent gradients  $\gamma_i = \tau_i/\beta$  and the sectoral land shares. The last column of table 2.1 shows that we find transportation costs of services significantly higher (1.71%) than those of manufacturing and agriculture (0.52%, 0.81%). These rent gradients are in line with estimates of Schmenner (1981) and Eberts and Gronberg (1982) and are lower than historical rent gradients in New York City (Atack and Margo 1998). We hold these estimated technology parameters constant across countries and cities.

**Utility parameters.** We estimate the utility function (1) in cross-country data from 2007. Expenditure shares ( $\{x_i\}$ ) are from the 2005 wave of the International Comparison Program (Bank 2005). We calculate sectoral price levels ( $\{P_i\}$ ) from the International Comparison Program’s disaggregate data on 24 product headings. We measure per capita income by purchasing power parity adjusted GDP per capita ( $y$ ).

We estimate the following equation for expenditure share of sector  $i = 1, 2, 3$  in country  $c$  by non-linear least squares,

$$x_{ic} = \frac{\alpha_i \lambda(y_c)^{-\sigma_i} P_{ic}^{1-\sigma_i}}{\sum_j \alpha_j \lambda(y_c)^{-\sigma_j} P_{jc}^{1-\sigma_j}} + \varepsilon_{ic}, \quad (21)$$

where  $\lambda(y_c) = b y_c^{-1/\sum_j x_{j0}\sigma_j}$  is the first-order Taylor approximation of marginal utility around average expenditure shares  $\{x_{j0}\}$ , and  $\varepsilon_{ic}$  is an error term independent of income and prices.<sup>10</sup>

[FIXME: sigma has to be greater than 1. Take from Fieler 2011]

Our estimated elasticities are  $\sigma_1 = 0.45$ ,  $\sigma_2 = 0.46$  and  $\sigma_3 = 0.16$ . The model fits the expenditure share data quite well, with an  $R^2$  between 0.86 for manufacturing and 0.95 for services. The model captures the fact that the expenditure share of agriculture is decreasing in income by estimating a low  $\sigma_3$ . The income elasticities of manufacturing and services are not significantly different from one another.

Figure 3 plots the estimated expenditure shares against GDP per capita of the country. Note that because these shares also depend on prices, the univariate relationship is necessarily noisy. The well-known pattern of structural transformation is visible.<sup>11</sup> The share of services is steadily growing with development, while the share of agriculture is shrinking and eventually vanishes. Manufacturing follows a hump shaped pattern with development.

## 2.2 Recovering city-level parameters

We use city-level data on land area, employment and GDP per capita from the the OECD Metropolitan Areas database (OECD 2012). Our sample includes 277 cities across OECD countries with non-missing area and employment data in 2007.<sup>12</sup> Cities

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<sup>10</sup>To be precise, since we are only approximating  $\lambda$ , higher-order terms in income will show up in the error term. As our results do not change when we include second-order terms in income, this effect is likely quantitatively small.

<sup>11</sup>See, for example, Buera and Kaboski (2012) for recent cross-country estimates of how expenditure shares depend on development.

<sup>12</sup>We impute employment from population for three cities in Switzerland.

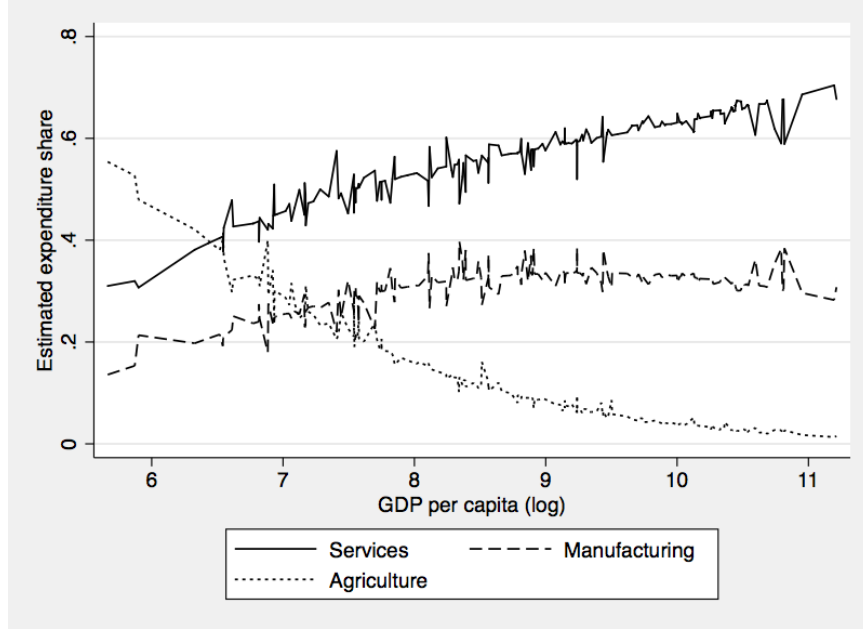


Figure 3: Estimated expenditure shares and GDP per capita  
Fitted values of regression (21) plotted against log GDP per capita. Estimates also depend on sectoral relative prices, leading to variation independent of income.

are defined as “functional urban areas,” and are typically extend beyond the administrative boundaries. For US cities, they roughly correspond to Metropolitan Statistical Areas. To obtain variation in expenditure shares across cities, we use the model-consistent expenditure shares predicted by our estimated utility function.

The following equations completely characterize the spatial equilibrium of city  $c$ . The relative employment of two cities,

$$\frac{N_c}{N_{c'}} = \frac{(A_c)^{1/\beta} e^{-\tilde{z}_c \tau / \beta} L_c}{(A_{c'})^{1/\beta} e^{-\tilde{z}_{c'} \tau / \beta} L_{c'}}$$

depends on relative productivity, a relative “congestion” term and relative city area.

Relative city boundaries,

$$e^{(z_c - z_{c'}) \tau} = \frac{A_c}{A_{c'}}.$$

Because we do not observe city area for many cities, we can use the above relationship to calibrate city areas to city populations.

$$\frac{N_c}{N_{c'}} = \frac{e^{(z_c - \tilde{z}_c) \tau / \beta} \tilde{z}_c^2}{e^{(z_{c'} - \tilde{z}_{c'}) \tau / \beta} \tilde{z}_{c'}^2}$$

$$N_c = \text{constant} \times e^{(z_c - \tilde{z}_c) \tau / \beta} \tilde{z}_c^2$$

The right-hand-side is strictly increasing in  $z_c$ , which we can use to pin down the boundary of each city. [FIXME: we need an overall level of urban population density. This can be take from just one city per country?]

Table 3: Estimate of utility function parameters

	(1)	(2)	(3)
	$\ln Cu$	$\ln Cr$	$\ln(Pu/Pr)$
$\ln Ac$ (country average)	1.911*** (0.402)	-0.297*** (0.0887)	
$\ln Ar$	-0.785** (0.335)	1.270*** (0.0800)	
$\ln(L/N)$	-0.0267 (0.0590)	0.150*** (0.0140)	
$\ln Cu$			-0.352*** (0.0828)
$\ln Cr$			0.450*** (0.0698)
Constant	-4.728* (2.386)	0.364 (0.460)	-1.610* (0.824)
Observations	29	29	29
$\sigma u$			2.840
$\sigma r$			2.224

Standard errors in parentheses

Instrumental variables regression.

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

### 3 Decomposition of output per worker

### 4 Conclusion

We introduced location choice in a multi-sector general equilibrium model. Producers in agriculture, manufacturing and services choose their location to trade off land rents

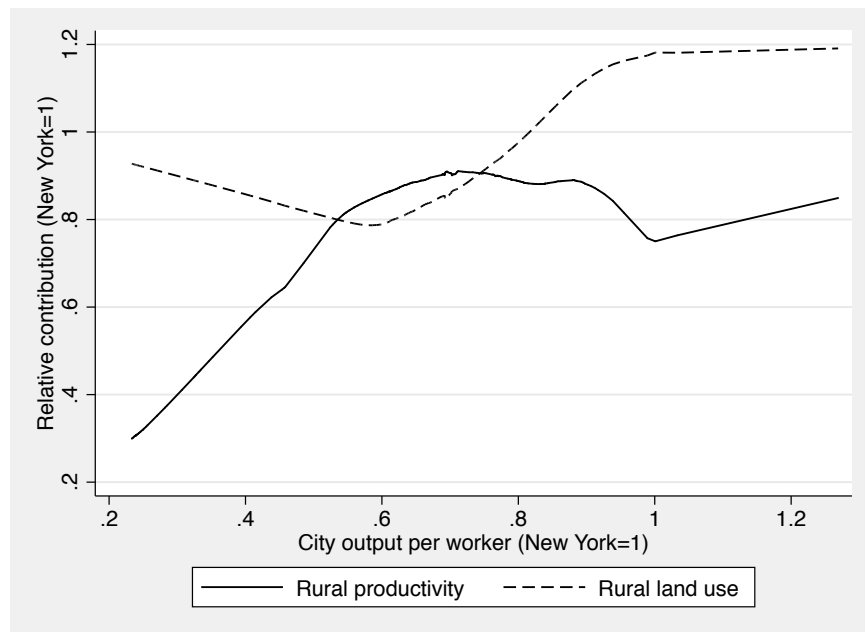


Figure 4: The contribution of rural productivity and land use to city output per worker

Notes: Figure presents the nonparametric relationship between city-level output per worker and rural productivity and land per worker using locally weighted scatterplot smoothing. All productivity contributions are expressed relative to those in New York.

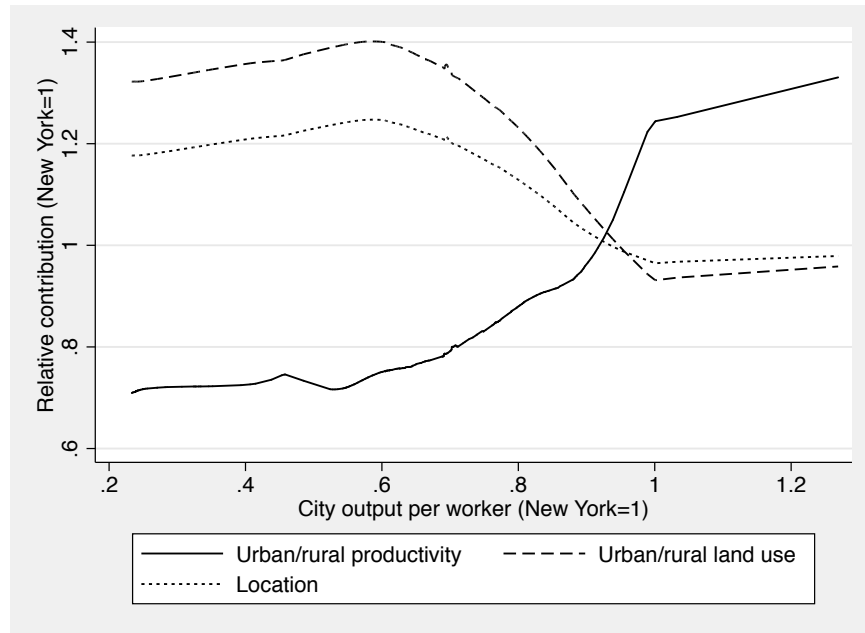


Figure 5: The contribution of urban productivity, land use and location to city output per worker

Notes: Figure presents the nonparametric relationship between city-level output per worker and relative urban/rural productivity, relative land per worker and the contribution of the location friction using locally weighted scatterplot smoothing. All productivity contributions are expressed relative to those in New York.



Table 4: Counterfactual values of aggregate variables relative to actual values

	(1)	(2)
	100% increase in productivity	10% increase in demand for urba
	mean	mean
Urban relative price	1.017	1.008
Urban land	1.081	1.042
Rural land	0.996	0.998
Urba output per worker	1.974	0.993
Rural output per worker	2.007	1.002
Constant-price GDP	2.009	1.002

Notes: Table presents ratio of counterfactual aggregate variables to the actual value in two counterfactual scenarios. The first column reports the scenario when all rural and city productivities double in all countries. The second column reports the scenarion when the demand shifter of rural goods increases by 10% in all countries.

with transport costs to the city center. We showed how space affects the aggregate production function and decompose output per worker into productivity, land per worker, and a term adjusting for sector location. In our model, services are luxury goods. As a result, richer cities have larger service cores, higher service prices, and relatively less output per worker in services. These predictions are broadly consistent with the data. We calibrated our model to data on cities in OECD countries and showed that land and location explain 10–30 percentage points of the variation in output per worker.

In our calibration, sectoral productivities varied to the same extent across cities. This leaves less room for technology-based explanations as to why sectoral output per worker and sectoral prices vary with development.

We see two avenues for further research. First, the number and size of cities within countries can be endogenized to see how this contributes to aggregate outcomes (Desmet and Rossi-Hansberg 2013; Ramondo, Rodríguez-Clare, and Saborío-Rodríguez 2016). Second, urbanization patterns may be very different in less developed countries (Glaeser 2014; Harari 2016). The model can be calibrated to richer data on transport costs and land use across cities around the globe.

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# Appendix

## A Proofs

### A.1 Proof of Proposition 1

We first show that the allocation of space across sectors follows a strict partitioning, and hence can be characterized by two cutoffs:  $z_1$  denotes the boundary between services and manufacturing and  $z_2$  denotes the boundary between manufacturing and agriculture. We then apply Brouwer's fixed point theorem to show there exist such equilibrium cutoffs.

First note that profit maximization requires  $R_i(z) \geq R(z)$  for all industries and locations and a strict inequality implies that  $Q_i(z) = 0$ . Because the three bid-rent curves have different slopes, they can only intersect at a measure zero set of points. Hence all locations are used by a single industry, there is no mixed use.

The single-crossing property of bid-rent curves imply a strict partitioning. For any pair of sectors with  $\tau_i/\beta > \tau_j/\beta_j$  we have  $\sup\{z : Q_i(z) > 0\} \leq \inf\{z : Q_j(z) > 0\}$ . That is, all sector  $i$  locations are closer to the CBD than any sector  $j$  location.

Equation (3) ensures positive demand for all three products so that all three sectors are active. The only such partitioning is where  $\{z : Q_1(z) > 0\} = [0, z_1]$ ,  $\{z : Q_2(z) > 0\} = (z_1, z_2]$  and  $\{z : Q_3(z) > 0\} = (z_2, z_3]$ . At these boundaries, a rent arbitrage condition holds:

$$R_i(z_i) = R_{i+1}(z_i). \quad (22)$$

To use Brouwer's fixed point theorem, construct the following mapping. Take a pair of  $z_1 < z_2 \in [0, z_3]$ . Denote the set of admissible  $z$ s by  $Z = \{(z_1, z_2) : z_1 < z_2 \in [0, z_3]\}$ , which is a compact and convex set. Let  $W \equiv 1$  serve as the numeraire. Use the rent arbitrage condition at the boundaries (22) and the resource constraint for aggregate labor

$$N = \sum_{i=1}^3 \int_{z=z_{i-1}}^{z_i} (1-\beta)^{1/\beta} (P_i A_i)^{1/\beta} e^{-z\tau_i/\beta} \bar{L}(z) dz,$$

to solve for prices  $P_1$ ,  $P_2$  and  $P_3$ . These prices are a continuous function of  $(z_1, z_2)$ . Given these prices, solve for utility-maximizing expenditure shares  $(x_1, x_2, x_3)$ . The total amount of rents payable to each sector can then be expressed, in relative terms, as

$$\frac{R_i}{R_j} = \frac{\beta x_i}{\beta_j x_j}.$$

Let  $(z'_1, z'_2)$  be the sector boundaries consistent with these relative rent amounts. Clearly,  $(z'_1, z'_2) \in Z$  and the mapping is continuous. Applying Brouwer's fixed point

theorem, there exists a  $(z_1^*, z_2^*)$  such that  $(z_1'^*, z_2'^*) = (z_1^*, z_2^*)$  and all equilibrium conditions hold with equality. Q.E.D.

## A.2 Proof of Proposition 3

We will verify that when  $d \ln A_i = \kappa$  for all  $i$ ,  $d \ln P_i = -\kappa$  is an equilibrium. Because resource allocations across sectors and space only depend on  $P_i A_i$ , these will not change. Output in each sector goes up by  $d \ln Q_i = \kappa$ . Because preferences are homothetic and relative prices have not changed, expenditure shares remain constant. They are hence still consistent with the equilibrium. Q.E.D.

## A.3 Proof of Proposition 4

Let  $d\mathbf{z}$  denote the  $2 \times 1$  vector  $(dz_1, dz_2)$ ,  $d\mathbf{b}$  denote the  $3 \times 1$  vector with elements  $d \ln(P_i A_i / W) / \beta$ , and  $d\mathbf{q}$  denote the  $3 \times 1$  vector with elements  $d \ln(P_i Q_i / W)$ .

Totally differentiating the production function (23) (below) yields

$$d\mathbf{q} - d\mathbf{b} = \mathbf{M}_1 d\mathbf{z},$$

where  $\mathbf{M}_1$  is a  $3 \times 2$  matrix,

$$\mathbf{M}_1 = \begin{bmatrix} e^{-z_1 \tau_1 / \beta_1} \bar{L}(z_1) / \tilde{L}_1 & 0 \\ -e^{-z_1 \tau_2 / \beta_2} \bar{L}(z_1) / \tilde{L}_2 & e^{-z_2 \tau_2 / \beta_2} \bar{L}(z_2) / \tilde{L}_2 \\ 0 & -e^{-z_2 \tau_3 / \beta_3} \bar{L}(z_2) / \tilde{L}_3 \end{bmatrix}.$$

Totally differentiating the rent arbitrage condition (22) yields

$$\mathbf{M}_2 d\mathbf{b} = d\mathbf{z},$$

where  $\mathbf{M}_2$  is a  $2 \times 3$  matrix,

$$\begin{bmatrix} \frac{1}{\tau_1 / \beta_1 - \tau_2 / \beta_2} & \frac{-1}{\tau_1 / \beta_1 - \tau_2 / \beta_2} & 0 \\ 0 & \frac{1}{\tau_2 / \beta_2 - \tau_3 / \beta_3} & \frac{-1}{\tau_2 / \beta_2 - \tau_3 / \beta_3} & 0 \end{bmatrix}.$$

Combining these two equilibrium conditions, we can express the changes in sector boundaries as a function of changes in sector shares,

$$d\mathbf{z} = \mathbf{M}_2 (\mathbf{I} + \mathbf{M}_1 \mathbf{M}_2)^{-1} d\mathbf{q} \equiv \mathbf{M}_3 d\mathbf{q}.$$

The  $2 \times 3$  matrix  $\mathbf{M}_3$  has the structure

$$\mathbf{M}_3 = \begin{bmatrix} \kappa_1 + \kappa_2 & -\kappa_1 & -\kappa_2 \\ \kappa_3 & \kappa_4 & -(\kappa_3 + \kappa_4) \end{bmatrix}$$

for some positive  $\kappa$ s.

Using equation (4) for the income elasticity of consumption in each of the three sectors,  $dz_1/d \ln y > 0$  whenever

$$\sigma_1 > \frac{\kappa_1}{\kappa_1 + \kappa_2} \sigma_2 + \frac{\kappa_2}{\kappa_1 + \kappa_2} \sigma_3,$$

which holds for because  $\sigma_1 > \sigma_2 > \sigma_3$ .

Similarly,  $dz_2/d \ln y > 0$  whenever

$$\sigma_3 < \frac{\kappa_3}{\kappa_3 + \kappa_4} \sigma_1 + \frac{\kappa_4}{\kappa_3 + \kappa_4} \sigma_2,$$

which holds for because  $\sigma_1 > \sigma_2 > \sigma_3$ . The amount of land usage and relative prices follow from the equilibrium conditions. Q.E.D.

## A.4 Proof of Proposition 2

Let us express value added (measured at the center) at a location  $z$  per unit of land:

$$\frac{e^{-\tau_i z} Q_i(z)}{L_i(z)} = e^{-\tau_i z} A_i(z) \left( \frac{N_i(z)}{L_i(z)} \right)^{1-\beta} = (1-\beta)^{1/\beta-1} A_i^{1/\beta} \left( \frac{W}{P_i} \right)^{1-1/\beta} e^{-\frac{\tau_i}{\beta} z},$$

where we used equation 9 on employment density. From this, total supply of sector  $i$  becomes

$$\tilde{Q}_i = \int_{z \in Z_i} \frac{e^{-\tau_i z} Q_i(z)}{L_i(z)} L_i(z) dz = (1-\beta)^{1/\beta-1} (A_i)^{1/\beta} \left( \frac{W}{P_i} \right)^{1-1/\beta} L_i e^{-\frac{\tau_i}{\beta} \tilde{z}_i}. \quad (23)$$

by the definition of the representative location of the sector in equation 12.

Overall employment in the sector,

$$N_i = \int_{z \in Z_i} \frac{N_i(z)}{L_i(z)} L_i(z) dz = (1-\beta)^{1/\beta} \left( \frac{P_i A_i}{W} \right)^{1/\beta} L_i e^{-\frac{\tau_i}{\beta} \tilde{z}_i},$$

so that we can express  $W/P_i$  as

$$\frac{W}{P_i} = (1-\beta) N_i^{-\beta} A_i L_i^\beta e^{-\tau_i \tilde{z}_i}$$

Substituting this result to equation (23), we obtain the aggregate production function. Q.E.D.

## Response to the Editor

Dear Diego,

Thank you for giving us the opportunity to revise our paper and for your and the referees' constructive comments. We believe the revised version has significantly improved and we hope you will find it acceptable for publication. Below we summarize the major changes, followed by a point-by-point reply to referees.

**Cities vs countries.** In our previous version, our analysis has jumped back and forth between cities and countries in a confusing manner. Both referees pointed out the restrictive assumptions needed to study cities in isolation.

To maintain the analytical tractability of our model, we have kept the baseline analysis at the city level. We have correspondingly reworded our Introduction (pages XX) to avoid overselling our results. We also added a new Section XX, which explicitly aggregates up the city-level results to the country level. Our language is still cautious here, as our baseline model has little to say about the system of cities within a country. [We added Appendix XX to illustrate how a richer model can be used to study multiple cities within the same country.]

**Better connection to literature.** We acknowledge the importance of earlier work in this literature and have rewritten the Introduction (pages XX) to carefully delineate our contribution. Indeed, the importance of land use, land restrictions and transport infrastructure for development has been highlighted by XX and XX. Our contribution is to study how the endogenous spatial sorting of sectors affects aggregate productivity.



## Response to Referee 1

## Response to Referee 2