

Discussion Paper No. 01-66

**The Impact of Office Machinery  
and Computer Capital on the Demand  
for Heterogeneous Labor**

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Zentrum für Europäische  
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# The Impact of Office Machinery and Computer Capital on the Demand for Heterogeneous Labor\*

Martin Falk<sup>†</sup>

March 5, 2002

## Abstract

This paper analyzes the impact of office machinery and computer capital (OCM) on the demand for heterogeneous labor. A system of static and dynamic factor demand equations based on a variant of the generalized Box-Cox cost function nesting the translog, the generalized Leontief and the normalized quadratic functional form is derived and estimated. OCM capital and general capital are treated as quasi-fixed factors. Using panel data on 35 German industries, we find that OCM capital is complementary to all skill levels. For the manufacturing sector, the increase in OCM capital and general capital has accounted for at least 60 percent and 9 percent of the expanding employment of university graduates. In non-manufacturing industries, we find that an increase in general capital tends to reduce unskilled workers. Wage effects and substitution effects between different types of labor and material inputs play a minor role in explaining employment changes of highly skilled workers and medium-skilled workers but these effects are more important in explaining the demand for unskilled workers.

**Keywords:** skill-biased technological change, capital-skill complementarity

**JEL Classification:** J23, O33

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\*I would like to thank B. Van Ark, R. Lucchetti, J. Möller, N. Mulder, M. Timmer, A. Sterlacchini, W. Oberhofer for helpful comments and A. Müller for providing us with the computer investment data. Financial support from the European Commission under the project ‘Employment prospects in the knowledge economy’ is gratefully acknowledged.

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## 1. Introduction

The diffusion of information and communication technology (ICT) is often emphasized as one of the most important factors explaining the shift in labor demand towards skilled workers and away from unskilled workers (see among others, Autor, Katz and Krueger, 1998; Morrison-Paul and Siegel, 2001). During the 1980s and 1990s, the total stock of computing equipment grew rapidly as computer power exploded and prices of computers fell greatly (see Jorgenson 2001). For the U.S., the total stock of quality adjusted computing equipment in constant prices grew rapidly with average growth rates between 20 and 30 percent per year (Jorgenson 2001). German figures show similar tendencies.

Krusell et al. (2000) investigate the impact of technological change on the ratio of skilled labor wages to unskilled labor wages using U.S. time series data. The authors find that capital-embodied technological change alone can account for most of the variations in the skill premium over the last 30 years. A key element of the Krusell et al. (2000) analysis is the use of quality-adjusted prices for a number of durable equipment categories such as office and computing equipment including peripheral equipment and accounting machinery (OCAM), communication equipment, general industrial equipment and transportation equipment. There has been a strong decline in the relative price of equipment (ratio of the price index for capital equipment and the price index for consumption of non-durables and services) of about 7 percent per year and an associated strong increase in the stock of equipment. The results imply that technological change is driven by the cheapening of equipment relative to structures and that technological change leads to a change in the composition of the capital stock.

Furthermore, there have been many empirical studies that focus directly on the relationship between the demand for labor at different skill levels and computerization (for a survey of the literature see Chennells and Van Reenen, 1999). Two empirical approaches have been used to estimate the relationship between the computerization and labor demand. The first approach relates the change in the employment share of skilled labor to the ratio of an industry's initial ICT capital (or ICT investment) to its total capital (or total investment). Alternatively, the change in the employment share of skilled labor is related to the change in ICT investment ratio (Autor, Katz and Krueger 1998). Berman, Bound and Griliches (1994) find that the change in the cost share of non-production workers is positively related to the industry's initial ratio of investment in computers to total investment. The computer variable accounts for about one third of the change

in the non-production wage bill share. Using a number of different data sets for the U.S. on three- and four-digit industry level, Autor, Katz and Krueger (1998) extend previous work in a number of ways. First, they use different measures of skills (four educational qualification groups as well as different occupational groups), different measures of information technology as well as a longer time period. Second, the authors also consider non-manufacturing industries. Using three-digit industry data, Autor et al. (1998) find that the change in computer use (measured as the annual change in the fraction of workers using a computer at work) is positively related to the change in the employment share of college graduates and, to a lesser extent, to workers with at least two years of college. In contrast, the change in computer use is negatively related to the change in the employment share of high school graduates. The relationship between the change in computer use and the change in the employment share of workers with less than high school is not significantly different from zero. Furthermore, the authors suggest that the shift towards college-educated workers and away from high school-educated workers was greatest in industries that experienced the greatest rise in computer use. Finally, the authors find that computer investment can account for at least 30 percent of the increase in the non-production worker wage bill for the period 1959 –1989.

Using similar approaches, Machin and Van Reenen (1998) find further support for the computer-skill complementarity. The authors use the proportion of workers using a computer at work as an index of computer use. Using two-digit manufacturing data for the U.S. and U.K., they find that the change in the cost share of non-production workers between 1986 and 1990 is positively related to the initial proportion of workers using a computer at work. Green, Felstead and Gallie (2000) investigate the impact of computer usage at work and other job features on the changing skills required of workers for the U.K.. The data are based on individual data of employed persons at three data points: 1986, 1992 and 1997. The authors find that the spread of computer usage is very strongly associated with the process of upskilling throughout the period. For France, Goux and Maurin (2000) find that the decline in the unskilled share of French employment is mainly due to the slackness of domestic demand for those industries with the highest proportion of unskilled workers. In contrast, the spread of computers (measured amongst others as the percentage of workers using a computer on the job) has little effect on the labor demand for both skilled and unskilled workers.

The second approach employs a complete system of input demands, i.e. not only a relative labor demand equation (see Morrison-Paul and Siegel 2001 and

Fitzenberger 1999, Ruiz-Arranz 2001). Ruiz-Arranz (2001) extends the work of Krusell et al. (2000) by distinguishing between the effects of ICT capital and non-ICT capital. The author finds that ICT capital and skilled labour are strong complements and ICT capital is very substitutable to unskilled labour. However, the author does not find that non-ICT equipment is complementary to skilled labor. Morrison-Paul and Siegel (2001) investigate the impact of high-tech office and information equipment, R&D trade and outsourcing on heterogeneous labor demand. High-tech office and information equipment includes communications equipment, scientific and engineering instruments and photocopiers and related equipment in addition to office computing and accounting machinery. The authors estimate a seven equations input demand system derived from a generalized Leontief cost function with four educational qualification groups, energy and materials and an Euler equation for investment. Using U.S. two-digit manufacturing industry data, the authors find that the accumulation of high-tech capital explains 9 percent of the expanding employment of college graduates and 30 percent of the expanding employment of workers with some college experience for the period 1959-1989.

For Germany, Fitzenberger (1999) provides some evidence of the impact of computerization on labor demands for three types of labor (highly skilled, medium-skilled and unskilled workers) as well as materials. As neither OCM capital stock nor the price of OCM are available, Fitzenberger relies on the input coefficients (material inputs to total shipments) from the office machinery and computer industry and the electrical goods industry obtained from input-output tables as an indicator of embodied technological change. Using two-digit industry data for non-manufacturing industries for the period 1975-1990, he finds little evidence for skill-biased technological change in non-manufacturing industries. The finding of no significant impact of intermediate OCM inputs could be due to the fact that material inputs from the OCM industries do not seem to be correlated with OCM investment.<sup>1</sup>

This paper presents new empirical estimates of the impact of OCM capital on the demand for heterogeneous labor. A four-equation input demand system with three types of labor and total intermediate materials as variable factors as well as two types of capital (OCM capital and general capital) as quasi-fixed factors is derived and estimated. Since functional forms are often data-specific and empirical

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<sup>1</sup>The correlation coefficient between the change in OCM investment and the change in intermediate OCM inputs measured as annual average growth rates across non-manufacturing industries is -0.08 and not significantly different from zero.

results sensitive to the choice of the functional form of the cost function, elasticities are calculated using different flexible forms such as the generalized Box-Cox, the generalized Leontief, the normalized quadratic as well as the translog functional form. Furthermore, we combine the factor demand systems with a general dynamic adjustment process of each input factor. In particular, we estimate multi-equation error-correction models suggested by Anderson and Blundell (1982). As noted by Anderson and Blundell (1982), the advantage of these models is that it nests simpler dynamic specifications, such as the partial adjustment model as well as the static model or the model in first differences. To our knowledge, this paper presents the first application of a multi-equation error-correction model assuming a generalized Box-Cox functional form of the cost function. Workers are classified according to whether they have a university degree, a certificate from the dual vocational system including masters and technicians and workers without any formal degree. The data consists of panel data on 35 two-digit industries for the period 1978 – 1994.

The paper proceeds as follows. Section 2 outlines the specification of both the generalized Box-Cox cost function, the normalized quadratic, the Leontief cost function and the translog cost function as well as the derived factor demands, while section 3 describes and summarizes the data. Section 4 presents the elasticities of the factor demand system as well as a decomposition analysis of the employment changes into output, capital and price effects. Section 5 concludes.

## 2. The empirical model

Most earlier work on the demand for heterogenous labor employs either the translog or the generalized Leontief cost function. The results of these studies, however, are difficult to compare because the different functional forms are not nested within a general functional form of the cost function. Therefore, an extension of Berndt and Khaled's (1979) Box-Cox cost function is considered here. This variant of a generalized Box-Cox cost function nests three different functional forms: (i) the translog cost function, (ii) the quadratic cost function and the generalized Leontief cost function. The generalized Box-Cox cost function can be written as:

$$c(p_{nt}, z_{nt}, a_n, \gamma) = \begin{cases} p'_{nt} \bar{x}_n (\gamma_2 C(P_{nt}, Z_{nt}; \alpha_{0n}) + 1)^{1/\gamma_2} & \text{for } \gamma_2 \neq 0 \\ p'_{nt} \bar{x}_n \exp(C(P_{nt}, Z_{nt}; \alpha_{0n})) & \text{for } \gamma_2 = 0 \end{cases}, \quad (2.1)$$

where

$$C(P_{nt}, Z_{nt}; \alpha_{0n}) = \alpha_{Cn} + A_{pn}P_{nt} + A_z Z_{nt} + \frac{1}{2}P'_{nt}A_{pp}P_{nt} + P'_{nt}A_{pz}Z_{nt} + \frac{1}{2}Z'_{nt}A_{zz}Z_{nt}. \quad (2.2)$$

where the subscripts  $t$  and  $n$  denote time and industry, respectively. The technological parameters to be estimated are gathered in the vector  $\alpha_n = (\alpha'_{0n}, \gamma_1, \gamma_2)'$ , where  $\alpha_{0n}$  entails all free parameters of  $\alpha_{Cn}$ ,  $A_{pn}$ ,  $A_z$ ,  $A_{pp}$ ,  $A_{pz}$  and  $A_{zz}$ . Notice that subscript  $n$  characterizes parameters which are industry-specific. The vector of variable inputs is defined as  $x_{nt} = (x_{hnt}, x_{snt}, x_{unt}, x_{mnt})'$  and the prices as  $p_{nt} = (p_{hnt}, p_{snt}, p_{unt}, p_{mnt})'$ , where the labor input  $x_{hnt}$  denotes the number of workers with a university degree,  $x_{snt}$  denotes workers with a certificate from the dual vocational system plus masters and technicians,  $x_{unt}$  low-skilled or unskilled workers and  $x_{mnt}$  total materials. Labor is measured in total workers (full-time equivalents). The net capital stock (excluding OCM capital),  $z_{ont}$ , and the OCM capital stock,  $z_{knt}$ , are the quasi-fixed factors. Other explanatory variables entering the cost function are the level of production,  $z_{ynt}$ , and a time trend  $t$ . The two types of capital, output and time are regrouped in a vector  $z_{nt} = (z_{knt}, z_{ont}, z_{ynt}, t)'$ . Total variable costs are measured as the sum of labor costs and total materials:  $c_{nt} = p'_{nt}x_{nt}$ . The definition of  $Z$ ,  $P$  and  $C$  will be amended later. Some restrictions are placed on the parameters in order for the Hessian of the cost function to be symmetric in  $P$  and  $Z$  for the number of parameters to be parsimonious:

$$\iota'_4 A_{pn} = 1, \quad A_{pp} = A'_{pp}, \quad A_{zz} = A'_{zz}, \quad A_{pz} = A'_{zp}, \quad \iota'_4 A_{pp} = 0, \quad \iota'_4 A_{pz} = 0, \quad (2.3)$$

where  $\iota_4$  denotes a  $(4 \times 1)$ -vector of ones. The components  $P_j$  and  $Z_j$  of the vector  $P$  and  $Z$  are transformations of the corresponding variables  $p_{jnt}$  and  $z_{jnt}$ :

$$Z_{jnt} = \begin{cases} \frac{z_{jnt}^{\gamma_1}}{\gamma_1} & \text{for } \gamma_1 \neq 0 \\ \ln z_{jnt} & \text{for } \gamma_1 = 0 \end{cases}, \quad j = k, o, y, \quad (2.4)$$

$$P_{jnt} = \begin{cases} \frac{(p_{jnt}/\theta'_n p_{nt})^{\gamma_1}}{\gamma_1} & \text{for } \gamma_1 \neq 0 \\ \ln(p_{jnt}/\theta'_n p_{nt}) & \text{for } \gamma_1 = 0 \end{cases}, \quad j = h, s, u, m. \quad (2.5)$$

The two parameters  $\gamma_1$  and  $\gamma_2$  capture the way that variables  $z_{jnt}$ , and  $p_{jnt}$  are transformed by the Box-Cox transformations. Note that in (2.4), the transformation is not applied to the time trend but only to general capital, OCM capital and



output. The  $(4 \times 1)$  vector  $\theta_n$  is equal to  $\bar{x}_n/\bar{p}_n'\bar{x}_n$ , where  $\bar{p}_n$  and  $\bar{x}_n$  are fixed levels of prices and quantities, so that  $\theta_n'p_{nt}$  corresponds to a Laspeyres price index for total variable costs. Note that both functions  $P_j$  and  $C$  are homogeneous of degree zero in prices, so that the multiplicative term  $\bar{p}'\bar{x}$  appearing in the Box-Cox function (2.1) ensures that the cost function is linearly homogeneous in prices.

The translog, the normalized quadratic as well as the generalized Leontief functional form are nested within the generalized Box-Cox specification and are obtained as special cases, for  $\gamma_1 \rightarrow 0$ ,  $\gamma_2 \rightarrow 0$  for  $\gamma_1 = 1$ ,  $\gamma_2 = 1$  and  $\gamma_1 = 0.5$ ,  $\gamma_2 = 1$ , respectively (see Koebel, Falk and Laisney, 2001). These restrictions are directly imposed in the cost function. For example, the normalized quadratic cost function as special case of a generalized Box-Cox cost function can be written as:

$$c(p_{nt}, z_{nt}; \beta_n) = p_{nt}'B_{pn} + \frac{1}{2} \frac{p_{nt}'B_{pp}p_{nt}}{\theta_n'p_{nt}} + p_{nt}'B_{pz}z_{nt} + \theta_n'p_{nt} \left( \beta_{0n} + z_{nt}'B_z + \frac{1}{2}z_{nt}'B_{zz}z_{nt} \right), \quad (2.6)$$

where the subscripts  $t$  and  $n$  denote time and industry, respectively.

The generalized Leontief can also be formulated as a special case of a generalized Box-Cox cost function (see Koebel et al. 2001):

$$c(p_{nt}, z_{nt}; \beta_n) = \sqrt{\theta_n'p_{nt}} (p_{nt}^{1/2})' B_{pn} + \frac{1}{2} (p_{nt}^{1/2})' B_{pp}p_{nt}^{1/2} + \sqrt{\theta_n'p_{nt}} (p_{nt}^{1/2})' B_{pz}z_{nt}^{1/2} + \theta_n'p_{nt} \left( \beta_{0n} + (z_{nt}^{1/2})' B_z + \frac{1}{2} (z_{nt}^{1/2})' B_{zz}z_{nt}^{1/2} \right). \quad (2.7)$$

The translog cost function can also be formulated as a special case of a generalized Box-Cox cost function. After the restrictions on the Box-Cox parameters ( $\gamma_1 \rightarrow 0$ ,  $\gamma_2 \rightarrow 0$ ) are imposed in the Box-Cox cost function a variant of the translog cost function is obtained (see Koebel et al. 2001):

$$c(p_{nt}, z_{nt}; \beta_n) = \beta_{0n} + (\ln p_{nt})' B_{pn} + (\ln z_{nt})' B_z + \frac{1}{2} (\ln p_{nt})' B_{pp} (\ln p_{nt}) + (\ln p_{nt})' B_{pz} (\ln z_{nt}) + \frac{1}{2} (\ln z_{nt})' B_{zz} (\ln z_{nt}). \quad (2.8)$$

For the different functional forms of the cost function, a system of optimal input demands  $x^*(p_{nt}, z_{nt}; \beta_n)$  is obtained by the application of Shepards' lemma

$(x^*(p_{nt}, z_{nt}, \beta_n) = \partial c^*/\partial p_{nt})$ . Then the system of four-input demand equations is divided by the output level:

$$x_{nt}/y_{nt} = x^*(p_{nt}, z_{nt}, \beta_n)/y_{nt} + e_{nt}, \quad (2.9)$$

where  $e_{nt}$  denotes a residual vector that has zero mean and a constant variance matrix and that is uncorrelated with the explanatory variables. The static quadratic and generalized Leontief factor demand system can be estimated by linear SUR with fixed effects. The translog factor demand system and specified as a special case of the Box-Cox cost function as well as the Box-Cox factor demand system have to be estimated by non-linear SUR. Note that the inclusion of industry dummies may not be sufficient to allow for heterogeneity across industries. For this purpose, we split the 24 manufacturing industries into durables and non-durables.

Since the existence of adjustment costs may lead to a delay in the adjustment of factors to changes in output and prices, a dynamic specification of the factor demand system may fit the data better than a static model. Therefore, the factor demand system derived from the different cost functions can be combined with a general dynamic adjustment process of each input factor. In particular, we employ the general dynamic approach suggested by Anderson and Blundell (1982). The advantage of the GECM is that it nests a variety of dynamic specifications, such as the partial ECM, the partial adjustment model or the static model with or without a first-order autoregressive error term. The GECM of the four-equation system can be written as:

$$\begin{aligned} x_{nt}/y_{nt} - x_{n,t-1}/y_{n,t-1} &= D_1 \left( x_{nt}^*/y_{nt} - x_{n,t-1}^*/y_{n,t-1} \right) \\ &+ D_2 \left( x_{n,t-1}^*/y_{n,t-1} - x_{n,t-1}/y_{n,t-1} \right) + \varepsilon_{nt}, \end{aligned} \quad (2.10)$$

where both matrices  $D_1$  ( $4 \times 4$ ) and  $D_2$  ( $4 \times 4$ ) entail the unknown parameters reflecting departure from the long-run model. The vector  $\varepsilon_{nt}$  is assumed to have zero conditional mean and a constant conditional variance.

The complete model consists of 64 free parameters plus industry dummies which have to be estimated on the basis of  $35 \times 17$  observations. Several less general dynamic models are nested within the GECM. If the matrix  $D_1$  is diagonal, the GECM is reduced to the partial ECM. It is reduced to the simple ECM if both  $D_1$  and  $D_2$  are diagonal. The different dynamic specifications will be estimated by non-linear SUR. Starting values will be provided by the static models.

Furthermore, the GECM is reduced to the static model with an autoregressive error term if  $D_1$  is the identity matrix  $I_4$  and  $D_2 = I_4 - R$ , where  $R$  ( $4 \times 4$ ) is the

serial correlation matrix:

$$x_{nt}/y_{nt} = x_{nt}^*/y_{nt} - R \left( x_{n,t-1}^*/y_{n,t-1} - x_{n,t-1}/y_{n,t-1} \right) + \varepsilon_{nt}. \quad (2.11)$$

The model written in first differences is obtained if  $D_1 = I_4$  and  $D_2 = 0$ :

$$x_{nt}/y_{nt} - x_{n,t-1}/y_{n,t-1} = x_{nt}^*/y_{nt} - x_{n,t-1}^*/y_{n,t-1} + \varepsilon_{nt}. \quad (2.12)$$

Finally, the short- and the long-run model coincide if  $D_1 = D_2 = I_4$ :

$$x_{nt}/y_{nt} = x_{nt}^*/y_{nt} + \varepsilon_{nt}, \quad (2.13)$$

at the exception that the residual terms  $\varepsilon_{nt}$  are now serially uncorrelated, which was not necessary the case in (2.9).

There are two important issues about the estimation of the dynamic specification using panel data. First, it is well-known that in models which are linear in parameters, the fixed effects estimator with lagged dependent variables generates biased estimates. As proved by Nickell, the bias increases in the magnitude of the adjustment coefficients and decreases with the time dimension of each cross-section. This criticism also applies to the present non-linear GECM context where  $x_{n,t-1}/y_{n,t-1}$  and  $\varepsilon_{nt}$  may be correlated. Judson and Owen (1999), however, find that the bias mainly concerns the coefficients of the lagged endogenous variables. Since this paper focuses on capital and price elasticities rather than on the adjustment parameters, this issue is neglected here.

A second problem is the potential non-stationarity of the data. The time series dimension is quite large with 17 years for each industry. We do not apply panel unit root tests for two reasons. First, the time series dimension may still be too small to apply panel unit root tests. Second, given the fact that most of the variables are input-output ratios as well as relative prices, stationarity of the series is a plausible assumption. In this case, the error-correction model can still be used to distinguish between long-run and short-run effects.

The key elasticities are the long-run elasticities of the demand for labor at different skill levels with respect to the quantity of OCM capital,  $z_o$ , and non-OCM capital,  $z_k$ :

$$\epsilon \left( x_j^*, z_i \right) = \frac{\partial x_j^*}{\partial z_i} \frac{z_i}{x_j^*}, \quad (2.14)$$

where  $j = h, s, u$ , respectively and  $i = k, o$ , respectively. The main hypothesis to be tested is that unskilled labor is a substitute for OCM capital but highly skilled

workers are complementary to OCM capital. A positive sign indicates a complementary relationship. A weaker form of computer capital skill complementarity states that unskilled workers also benefit from the increase in the OCM capital stock; however, the effect is much lower than the impact of OCM capital on skilled or highly skilled workers.

### **3. Data and descriptive statistics**

The data sample used consists of panel data on 35 German industries for the period 1978 –1994. The basic data source are the National Accounts. From 58 industries, we selected a subset of 54 industries. The public sector as well as agriculture are excluded. Data availability reduces the sample to 35 industries. Data sources for wages and employment by different educational qualifications are described in Falk and Koebel (2001). Wages are measured as average annual salaries (plus fringe benefits and non-wage labor costs) paid to full-time workers and are calculated from the IABS. One drawback of this database is that earnings for university graduates are topcoded. In general, earnings of highly skilled workers can be calculated from the wage and salary statistics. This database, however, is limited in coverage, in particular for some non-manufacturing industries (for instance other market services). For these industries, we assume that the ratio of earnings between medium-skilled and highly skilled workers is similar to the corresponding ratio in the trade, transport and financial intermediation sector.

Investment in office machinery and computers (OCM) is taken from the IFO capital flow tables provided by the IFO institute (see Faust et al. 1999a, 1999b). These series are available for the western part of Germany for the period 1970 -1994 and including East Germany since 1995. In Germany, OCM investment data are defined by ownership rather than by the use of new computer equipment. OCM investment includes mainframes, personal computers, direct access storage devices, printers, terminals, tape drives, storage devices, office machinery equipment and photocopiers and related equipment (see the list of subcategories in Table 12 and 13 in the appendix). In the U.S., by contrast, photocopiers and related equipment are not included into the category office machinery and computers. In a broad sense, high-tech capital can be defined as "Information Processing Equipment" (IPE), consisting of communications equipment, scientific and engineering instruments, photocopiers and related equipment (see Morrison 1997, Morrison-Paul and Siegel 2001). Note that both OCM and IPE investment do not include software development, maintenance or related services. In recent

years, software and related services have often been included into IT capital (see Jorgenson 2001).

In order to obtain OCM investment in constant prices, nominal investment must be deflated by an investment deflator for OCM equipment. Unfortunately, hedonic price deflators for OCM investment or the output of the OCM industry do not exist for Germany (Deutsche Bundesbank 2000). For personal computers, some work is carried out by Moch (2001). He estimates quality-adjusted price indices for personal computers for the period 1985 to 1994 and finds that the prices of personal computers adjusted for exchange rate movements are declining as fast as in the U.S.. To deflate nominal investment, we employ the U.S. Bureau of Economic Analysis's (BEA's) price index for OCAM equipment adjusted for exchange rates movements, which partly uses hedonic techniques to correct for quality change. The use of the current exchange rates to convert foreign prices into local currency can be criticized. Alternatively, purchasing power parities for the OCM industry can be employed. However, they are difficult to construct. Another important criticism to the application of U.S. price indices to other countries is that the composition of products may differ between countries. Van Ark (2001) suggests that the U.S. deflator for OCM investment may lead to an exaggeration of the price decline, since computer hardware production in the U.S. mainly consists of PCs and semiconductors, whereas computer production in the EU is more dominated by the production of peripheral equipment. In order to overcome this problem, we also experiment with the French quality-adjusted price index of OCM equipment (including photocopiers) to deflate nominal OCM investment.<sup>2</sup> In addition, the share of office machinery in total OCM may also differ across countries. A priori, one may expect that the share of office machinery equipment in total OCM equipment is very small. Information on the composition of OCM investment, however, is not available - only information on sales of OCM. Table 14 in the appendix documents that the share of office machinery in total sales of the OCM industry is around 10 percent. Similar tendencies can be observed for the U.K.<sup>3</sup>

Price indices for OCAM equipment are taken from the NIPA Table 7.8 published by the U.S. Bureau of Economic Analysis (BEA). Separate price indices are available for computers and peripheral equipment, office and accounting equipment and photocopiers and related equipment. Starting from 1985, BEA has used

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<sup>2</sup>I would like to thank N. Mulder (CEPII) for providing us with the French price index of OCM equipment.

<sup>3</sup>Personal correspondence with Mary O'Mahony.

hedonic price indices for computer equipment to deflate its national accounts output and investment data (BEA 2001, Whelan 2000). It provides estimates for the quality-adjusted price index of computers and peripheral equipment for the period 1966 – 2000. The measured decline is 16.3 percent per year for computer and peripheral equipment for the period 1970 – 1999. In contrast, the prices of office and accounting equipment and photocopiers and related equipment increased by 1.2 and 2.5 percent over the period 1970 to 1999, respectively. This indicates that the official price deflators for these types of durable equipment may understate the true price decline. Indeed, Jorgenson (2001) and Krusell et al. (2000) argue that quality-adjusted deflators are restricted to few items (i.e. computers and peripheral equipment) and that deflators for other types of equipment probably understate the decrease in prices.

The decrease in the prices of OCAM equipment was accompanied by an investment boom and a change in the composition of OCAM investment. In the U.S., the share of computers and peripheral equipment in total OCAM equipment plus photocopiers and related equipment increased from 47 percent in 1970 to 84 percent in 2000 (both in nominal terms). In order to aggregate the three different price indices a Törnquist price index is constructed. The change in the Törnquist price index,  $\Delta P/P_{t-1}$  can be written as:

$$\frac{\Delta P_t}{P_{t-1}} = \sum_{i=1}^3 \frac{\Delta p_{it}}{p_{i,t-1}} \frac{1}{2} (s_{i,t} + s_{i,t-1}) \quad (3.1)$$

where  $\frac{\Delta p_{it}}{p_{i,t-1}}$  is the annual growth rate of the three product groups in year  $t$  and the  $s_{i,t}$  is the nominal investment share of the three product groups in year  $t$ . Three different U.S. price indices are constructed: (i) price index of OCAM equipment (without photocopiers and related equipment) adjusted for exchange rate movements, and (ii) price index of OCAM plus photocopiers and related equipment adjusted for exchange rate movements, (iii) price index of OCAM plus photocopiers and related equipment adjusted for exchange rate movements using PPP between the German mark and the U.S. dollar.

Figure 1 in appendix shows the movements of the resulting deflators expressed in German marks for the period 1970 to 1991. Figure 2 in appendix contains the development of the corresponding deflators for the period 1991 to 1999. Table 1 summarizes the evolution of the different deflators. We also include the French OCM investment deflator (adjusted for exchange rate changes) and the German deflator for OCM investment as well as the producer price index for the OCM industry. Both the U.S. and the French price index of OCM equipment rapidly

declined and this decline accelerated in the second half of the 1990s (see Figure 1 and 2). The U.S. price index falls between 7.2 and 9.6 percent per year between the period 1970 to 1991 depending whether or not photocopiers and related equipment are included (see Table 1). Note that the decline in the U.S. price index of OCAM equipment is consistent with the corresponding price index presented in Jorgenson and Stiroh (1995). The decline accelerated over the period 1991 to 1999 with growth rates ranging between 13 and 16 percent per year. The French price index of OCM equipment converted in German marks fell by 10 percent per year for the period 1991 to 1999 (see Table 1). Furthermore, the choice of the conversion method appears to be less important. The decline in the price index based on PPP rates to convert U.S. dollar price in German marks is very close to the price index based on current exchange rates. In Germany, by contrast, the implicit deflator of office machinery and computer equipment slightly increased for the period 1970 to 1985, remained stable over the period 1986 to 1994 and then began to slightly decline in 1995. It is obvious that the German investment deflator of OCM equipment is not appropriate to deflate nominal OCM investment in nominal prices into constant prices. The official producer price index for the office machinery and computers industry also seems not very reasonable. Table 1 shows that the decline is 1.2 percent per year between the period 1970 –1991 and about 4.4 percent per year between the period 1991 to 1999 (see also Schreyer 2001).

Table 1: Average annual changes in different price indices of OCM equipment

investment deflators, all adjusted for exchange rate changes	'70-'91	'91-'99
U.S. deflator of OCAM investment (BEA)	-9.6	-16.3
U.S. deflator of OCAM investment (Jorgenson & Stiroh '95)	-10.2	n.a.
French deflator of OCM investment (INSEE)	-8.4	-10.0
U.S. deflator of OCAM + photocopiers (BEA)	-7.2	-13.2
U.S. deflator of OCAM + photocopiers (adj. using PPP)	-6.0	-14.9
German producer prices of the OCM industry	-1.2	-4.4
German implicit deflator of OCM investment	0.7	-0.8

Notes: Average annual percentage rates of growth. Price indices are converted to DM using current exchange rates. The U.S. price indices are constructed using the Törnquist formula. OCAM is defined as office, computing and accounting machinery. Source: U.S price indices: BEA, Table 5.8, 7.8.; Statistical Office Germany; INSEE; own calculations.

The OCM capital stock is constructed using the perpetual inventory method. Here, the U.S. depreciation rate is used to construct the OCM capital stock. Fraumeni (1997) reports a depreciation rate of office, computing, and accounting machinery of about 0.2729 for the years before 1978 and 0.3199 from 1978 onwards. These rates are high and they are higher than the implicit depreciation rates based on the German national accounts. The initial OCM capital stock is assumed to be equal to the OCM investment in constant prices in 1970 divided by the depreciation rate. General capital is obtained by subtraction of OCM capital from total capital. Figure 3 in appendix shows the evolution of the OCM capital stock in total manufacturing using different deflators for OCM investment. Based on the U.S. deflator and the French deflator, the average growth rates of the OCM capital stock across manufacturing industries range between 20.4 and 22.4 percent per year. Since the investment deflator is falling quickly, much of the measured real growth rate of the OCM capital stock may actually be attributable to the deflator. The general conclusion is that the change in the OCM capital stock is not sensitive to the choice of the deflator except for the German deflator. Based on the German deflator the growth rate of the OCM capital stock is about 10 percent per year.

Table 2 presents summary statistics on the average annual change in quantities and factor prices for 24 manufacturing and 15 non-manufacturing industries over the period 1978 –1994. The OCM capital stock in constant prices grew at a faster rate than all other inputs. Over the period 1978 –1994, the OCM capital stock increased by 21 percent per year in manufacturing and 23 percent per year in non-manufacturing industries (unweighted means based on 24 and 15 industries, respectively). For the U.S. economy, the annual average percentage growth rate of the OCAM capital stock is about 29 percent for the period 1978 to 1992 (see Jorgenson and Stiroh 1995). For the German manufacturing sector, Faust et al. (1999b) estimate that the OCM capital stock plus communication equipment in constant prices rose by about 10 percent per year over the period 1960 –1994.

Table 3 and Table 4 contain the sectoral breakdown of the average annual growth rate of the OCM capital stock, the share of OCM capital in total capital in 1994 (in real terms) and OCM investment as percentage of total investment (in nominal prices), respectively. For the period 1978 –1990, the share of investment in OCM equipment in overall investment exhibits a clear upward trend. Since 1991, the share of investment in OCM equipment has been declining. This suggests that the increase in the OCM capital stock between 1978 and 1991 is not only due to the falling OCM deflator but also due to rising investment. Table 3 shows



Table 2: Average annual changes in input quantities and factor prices

	mean	s.d.	min	max	mean	s.d.	min	max
	<b>manufacturing</b>				<b>non-manufacturing</b>			
	% change in input quantities and output							
highly skilled labor, $x_h$	3.6	1.9	-1.6	7.5	5.0	3.4	-2.2	11.5
skilled labor, $x_s$	0.1	1.6	-3.7	3.5	1.4	2.1	-2.5	4.1
unskilled labor, $x_u$	-3.9	1.6	-7.2	-0.2	-2.7	3.0	-9.3	1.8
total materials, $x_m$	1.6	1.7	-1.4	5.7	2.6	2.3	-0.5	7.8
general capital, $z_k$	0.4	2.1	-3.9	4.6	2.3	2.6	-3.4	7.2
OCM capital, $z_o$	20.6	1.9	15.4	24.2	23.0	3.7	17.7	30.5
gross output, $z_y$	1.0	1.8	-2.4	5.4	2.6	2.6	-1.1	7.6
	% change in factor prices							
highly skilled labor, $p_h$	4.5	0.2	4.0	4.9	4.4	0.2	4.1	4.8
skilled labor, $p_s$	4.2	0.3	3.7	4.9	4.3	0.5	3.8	5.1
unskilled labor, $p_u$	4.5	0.3	3.9	5.1	4.6	0.5	3.7	5.3
total materials, $p_m$	2.1	0.9	0.4	3.5	2.5	1.2	-0.1	4.1

Notes: Average annual percentage rates of growth for 24 and 15 industries over the period 1978-1994. We calculate the OCM capital stock using the U.S. depreciation rate. OCM investment is deflated by the U.S price index of OCAM equipment plus photocopiers adjusted for exchange rate changes. Source: Statistical Office Germany, IFO capital flow tables, Federal Labor Office, U.S. BEA: Table 7.8., own calculations.

that in total manufacturing, measured in nominal terms, the share of investment in office and computing machinery as percentage of total equipment investment, in nominal terms, rose from 4.5 percent in 1978 –1980 (means over the three year period) to 9.1 percent in 1985–1987 and then declined to 5.9 percent in 1992 –1994. The ratio of the office and computer machinery (OCM) capital stock to the total capital stock, measured in real terms, is about 3.5 percent in 1994. Furthermore, the office and computer machinery capital stock increased significantly in every sector. The highest OCM capital share can be observed in office machinery and computers with about 18 percent, followed by financial intermediations with 9 percent, aircraft with 7.4 percent, wholesale trade with 6.4 percent and publishing and printing with about 5.6 percent (see Table 3 and Table 4).

Based on a broader definition of OCM capital, Faust et al. (1999b) report

Table 3: Shares of OCM capital and OCM investment, **manufacturing** industries

industry	OCM capital, real terms		OCM investment share, %		
	share, '94	%-change	'78-'80	'85-'87	'92-'94
Chemicals, petroleum, rubber	2.5	19.0	2.6	7.9	4.3
Plastics	2.6	24.2	2.2	5.1	4.2
Stone and Earth	1.3	18.7	1.1	3.7	1.6
Ceramics	2.8	17.8	3.2	10.1	4.9
Glass	2.2	19.7	2.3	7.1	3.2
Iron and steel	2.1	15.4	2.6	8.3	4.3
Non-ferrous metals	3.0	21.5	2.8	8.4	4.9
Foundry	2.9	20.2	2.9	8.9	5.0
Fabricated Metals	3.1	20.7	3.1	8.0	6.0
Steel and light metal	3.3	21.4	2.8	8.6	5.0
Machinery	3.9	21.1	4.0	10.5	7.3
Office machinery, computers	18.0	8.8	51.2	31.7	39.5
Vehicles and repair services	3.7	24.0	2.9	7.7	5.8
Ships and boats	1.6	16.0	2.4	6.5	3.6
Aircraft and spacecraft	7.4	26.5	6.1	14.4	10.9
Electrical machinery	4.5	20.8	4.1	10.5	7.6
Instruments	4.3	22.0	4.3	10.6	7.8
Metal products	4.7	22.8	4.2	10.9	7.8
Musical instruments	4.8	21.5	5.0	12.6	9.3
Wood products	3.9	20.1	3.3	10.0	5.8
Furniture	4.2	20.9	3.6	11.5	7.1
Paper, paper products	3.0	22.0	3.5	7.5	5.3
Publishing and Printing	5.6	20.7	6.5	13.7	9.4
Leather	2.4	20.9	2.5	7.8	9.1
Textiles	2.2	18.7	3.0	6.7	6.5
Wearing apparel	2.7	20.5	2.9	7.8	7.6
Food	2.1	19.2	2.4	6.0	3.4
Total manufacturing	3.5	18.5	4.5	9.1	5.9

Notes: OCM capital share: share of OCM capital in total capital (both in constant 91er prices). Column 2: Average annual percentage rates of growth for the period 1978 to 1994. Source: See Table 2.

that in total manufacturing the share of OCM capital (including communications equipment) is about 4.7 percent in 1994 (in constant prices). For the U.S. economy, Jorgenson (2001) reports that, measured in nominal terms, the stock of all IT assets (computers, communication and software) combined accounts for 4 percent of the domestic capital stock in 1999, while the share of computer hardware capital is less than 1 percent. Based on a broader definition of OCM capital, Morrison (1997) finds that in U.S. manufacturing the share of high-tech equipment increased from 3 percent in 1976 to 15 percent in 1991.

Table 4: Shares of OCM capital and OCM investment, **non-manufacturing** industries

	OCM capital, real terms		OCM investment share, %		
	share, '94	% change	'78-'80	'85-'87	'92-'94
Electricity, steam, water	0.2	20.6	0.3	1.2	0.6
Coal mining	1.1	17.7	1.2	4.1	2.5
Construction	2.5	19.2	1.7	5.2	2.8
Wholesale trade	6.4	23.6	6.4	13.0	14.1
Retail trade	4.1	27.0	3.1	8.7	7.8
Railway transport	0.5	19.3	0.8	1.5	1.5
Water transport, waterways	1.8	21.2	0.7	2.2	2.7
Post and telecommunication	0.2	30.5	0.1	0.2	0.5
Other transport services	0.8	24.1	0.4	1.4	1.1
Financial intermediations	8.9	24.5	14.4	26.1	20.6
Insurance services	2.3	27.6	3.7	11.0	6.6
Hotel and restaurant industry	0.8	21.4	1.3	3.0	2.4
Science, education, publishing	2.0	23.1	2.5	5.3	3.3
Health	1.9	24.8	2.3	4.7	4.0
Other market services	5.4	18.0	16.1	17.9	9.1

Notes: see Table 2 and Table 3.

Figure 4 in the appendix shows a scatterplot between the ratio of the wage costs of highly skilled workers to total wage costs and the logarithm of the OCM capital stock per worker. The most skill-intensive sectors are science, education and publishing followed by office machinery and computers, as well as aircraft with a share of the total wage cost of highly skilled workers in total wages costs of about 30 percent and more. Other market services, the health sector and the electrical goods industry are also skill-intensive sectors. In these sectors, the

labor cost share of university graduates lies between 17 and 22 percent in 1994. A comparison of the ratio of the wage costs of highly skilled labor to total wage costs and the logarithm of the OCM capital stock per worker provides informal evidence that the skill-intensive sectors are the ones that exhibit a higher ratio of OCM capital stock per worker.

#### 4. Empirical results

The parameters of the four-input demand system assuming a Box-Cox or a translog functional form are estimated using non-linear *SUR* on panel data. Note that the quadratic factor demand system and the generalized Leontief factor demand system are linear in parameters. The complete static model assuming a generalized Box-Cox functional form of the cost function consists of 32 free parameters plus the Box-Cox parameters  $\gamma_1$  and  $\gamma_2$  and  $4 \times 35$  parameters for industry dummies which have to be estimated on the basis of  $35 \times 17 \times 4$  observations. 32 additional parameters have to be considered in the generalized error-correction model (GECM). For the partial error-correction model and the simple error-correction model, 20 and 8 adjustment parameters have to be estimated. In order to allow for heterogeneity across industries we estimate separate factor demand systems for the manufacturing sector and the non-manufacturing sector. The static factor demand system is also estimated for the durable manufacturing sector and non-durable manufacturing sector in order to allow for a different production technology across manufacturing industries.

Table 5 contains the estimates of the Box-Cox parameters  $\gamma_1$  and  $\gamma_2$  for the separate estimation samples. For the manufacturing sector, we also provide estimates of  $\gamma_1$  and  $\gamma_2$  obtained from the PECM. In most cases, the Box-Cox parameters  $\gamma_1$  and  $\gamma_2$  are either significantly different from zero or significantly different from one. Note that  $\gamma_1$  ranges between .13 and .33 indicating that both the GL and TL functional form are more appropriate in explaining the data than the normalized quadratic functional form.

Table 6 contains the values of the log-likelihood function obtained from the different functional forms of the cost function. For the panel of West German manufacturing industries, the values of the log-likelihood function obtained from the different static factor demand systems are 6,071.0 for the factor demand system assuming a generalized Box-Cox functional form, 5,962.7 for the translog factor demand system, 5,743.4 for the quadratic factor demand system and 5,930.4 for the factor demand system assuming a generalized Leontief functional form (see

Table 5: Estimates of the Box-Cox parameters

	$\gamma_1$	$\gamma_2$
static factor demand system		
non-durables	0.33 (14.60)	0.02 (0.17)
durables	0.20 (7.57)	0.30 (2.29)
total manufacturing	0.24 (12.80)	0.00 (0.01)
non-manufacturing	0.13 (3.47)	1.02 (8.05)
dynamic factor demand system		
total manufacturing <sup>a</sup>	0.25 (7.43)	0.08 (2.54)

Notes: t-values in parentheses. Estimation period is 1978-1994. The number of observations are 17×12 for durables, 17×12 for non-durables and 17×24 for total manufacturing and 17×11 for the non-manufacturing sector. <sup>a</sup>Estimates are based on the PECM.

Table 6). A likelihood ratio test indicates that the Box-Cox parameters ( $\gamma_1$  and  $\gamma_2$ ) are jointly significant at the 5 percent level in all cases (see Table 6). For non-manufacturing industries, the log-likelihood values are 2,506.4 for the factor demand system derived from the generalized Box-Cox function, 2,478.1 for the translog factor demand system, 2,424.5 for the quadratic factor demand system and 2,481.3 for the factor demand system assuming a generalized Leontief functional form. For the non-manufacturing sector, the null hypothesis that the Box-Cox parameters ( $\gamma_1$  and  $\gamma_2$ ) are jointly not significantly different from zero can also be rejected at the five percent level. Similarly, for the dynamic specifications (GECM for manufacturing and SECM for non-manufacturing) the translog, the normalized quadratic and the generalized Leontief functional form are rejected at the five percent significance level. Unreported results show that the log likelihood value of the generalized error-correction model assuming a generalized Box-Cox functional is lower than the log likelihood value of the translog functional form. The lower log likelihood value of the factor demand system assuming a generalized Box-Cox functional form may indicate that the global maximum is not achieved. Note that in some cases it may be difficult to achieve the global maximum since the dynamic factor demand system assuming a Box-Cox functional

Table 6: Log likelihood values of the factor demand system based on different estimation samples and different functional forms

	log-likelihood values				LR-test		
	Box-Cox (BC)	translog (TL)	normalized quadratic (NQ)	generalized Leontief (GL)	TL vs. BC	NQ vs. BC	GL vs. BC
static factor demand system							
non-durables	3,189.6	3,086.0	3,065.9	3,140.3	207.2*	247.4*	98.6*
durables	3,058.8	3,052.7	2,921.4	3,029.5	12.2*	274.8*	58.6*
manufacturing	6,071.0	5,962.7	5,743.4	5,930.4	216.6*	655.2*	281.2*
non-manuf.	2,506.4	2,478.1	2,424.5	2,481.3	56.6*	163.8*	50.2*
dynamic factor demand system							
manufacturing	6,946.4	6,923.6	6,862.3	6,903.3	45.6*	168.2*	86.2*
non-manuf.	3,160.4	3,100.9	2,965.1	2,987.4	110.0*	390.6*	346.0*

Notes: The five percent critical value of the LR-test is 5.99. See Table 5.

form is highly non-linear in parameters. The factor demand system specified as partial error-correction model or simple error-correction model produces more reliable estimates.

### Elasticities based on static factor demand models

In this section, we report elasticities obtained from estimating the static factor demand system. To conserve space, we present only the elasticities of factor demand obtained from the generalized Box-Cox functional form. Table 7 provides the elasticities of factor demand for the manufacturing sector based on split sample estimates distinguishing between durables and non-durables. The results of the LR test for the null of identical parameters across industries show that the pooled model can be rejected. The LR test is calculated as  $2 \times ((3,189.6 + 3,058.8) - 6,071.0) = 354.8$ , where 6,071.0 is the log-likelihood value of the pooled model and the first two log-likelihood values correspond to the log-likelihood values of the two split sample regressions. Under the null hypothesis, this test statistic is chi-squared distributed with 34 degrees of freedom (there are  $2 \times 34 - 34 = 34$  slope parameters which may be different in the split regressions). The five percent critical value is 48.32 which is much lower than the empirical value of 354.8. Table 8 provides the elasticities of factor demand for the non-manufacturing sector.

Elasticities were calculated at the midpoint data in 1986. Because the results for different industries are too voluminous to discuss in detail, we decided to report only the median elasticity as well as the t-statistic of the corresponding median elasticity. The elasticities of the different educational qualification groups with respect to OCM capital as well as general capital are given in row five and six of Table 7 and Table 8. A positive sign indicates a complementary relationship, whereas the negative sign indicates that the two inputs are substitutes. Output elasticities and the impact of time are provided in row seven and eight of Table 7 and Table 8. Own-price and cross-price elasticities of factor demand are given in the upper panel of Tables 7 and 8. Here a positive sign indicates that two inputs are substitutes.

Table 7: Elasticities of factor demand obtained from the static generalized Box-Cox cost function based on split sample, **manufacturing**

$\epsilon_{x_i^*, p_j}$	$x_h^*$	$x_s^*$	$x_u^*$	$x_m^*$
	price elasticities			
$p_h$	-0.30 (-0.61)	0.02 (0.45)	-0.04 (-2.70)	-0.00 (-1.17)
$p_s$	0.05 (0.45)	-0.21 (-5.47)	0.00 (0.00)	0.05 (5.07)
$p_u$	-0.48 (-2.68)	0.00 (0.00)	-0.29 (-4.03)	0.06 (4.26)
$p_m$	-0.22 (-1.15)	0.20 (5.71)	0.37 (6.74)	-0.11 (-6.90)
$\epsilon_{x_i^*, z_j}$	output, capital and time elasticities			
general capital, $z_k$	0.90 (4.96)	0.24 (5.74)	0.08 (2.86)	0.10 (3.38)
OCM capital, $z_o$	0.13 (4.64)	0.04 (2.74)	0.14 (4.39)	-0.01 (-0.69)
output, $z_y$	0.12 (0.67)	0.43 (6.68)	0.55 (17.28)	0.91 (26.37)
time, $t$	0.008 (2.01)	-0.003 (-0.89)	-0.063 (-9.09)	0.005 (1.47)

Notes: The number of observations is 408. The estimation period is 1978-1994. The median value of the elasticities is evaluated at 1986 data. t-values in parentheses. Price homogeneity is imposed for each industry but does not necessarily hold for the median elasticities

For manufacturing industries, the results indicate that an increase in the OCM capital stock is increasing the demand for highly skilled workers as well as the demand for medium-skilled workers. Contrary to expectation, we find a positive

Table 8: Elasticities of factor demand obtained from the static **generalized Box-Cox** cost function, **non-manufacturing**

$\epsilon_{x_i^*, p_j}$	$x_h^*$	$x_s^*$	$x_u^*$	$x_m^*$
	price elasticities			
$p_h$	-0.48 (-1.91)	0.08 (0.80)	0.18 (0.53)	-0.02 (-2.82)
$p_s$	0.64 (0.81)	-0.39 (-6.37)	0.29 (0.90)	0.09 (3.10)
$p_u$	0.28 (0.64)	0.08 (1.05)	-1.00 (-3.02)	0.07 (4.07)
$p_m$	-0.34 (-2.27)	0.18 (3.53)	0.64 (0.92)	-0.17 (-6.50)
$\epsilon_{x_i^*, z_j}$	capital, output and time elasticities			
general capital, $z_k$	1.17 (7.05)	0.47 (6.41)	-0.32 (-2.75)	-0.00 (-0.01)
OCM capital, $z_o$	0.07 (2.35)	0.09 (4.05)	0.15 (4.57)	0.06 (2.48)
output, $z_y$	-0.19 (-1.35)	0.00 (-0.05)	0.71 (7.92)	0.90 (15.25)
time trend, $t$	-0.010 (-1.48)	-0.016 (-3.66)	-0.040 (-6.11)	-0.010 (-1.82)

Notes: The number of observations is 187. See Table 7.

impact of the OCM capital stock on the demand for unskilled workers. Based on split sample estimates, the median elasticity of OCM capital stock with respect to highly skilled workers is about 0.13 and highly significant (see Table 7). The elasticities of the OCM capital stock with respect to medium-skilled workers and unskilled workers are 0.04 and 0.14, respectively and are also highly significant.

The median elasticity of general capital with respect to university graduates is about 0.90 and highly significant (see Table 7). The impact of general capital on both medium-skilled workers and unskilled workers is also positive and significant at five percent level but somewhat lower than the impact of capital on university graduates ( $\epsilon_{x_s^* z_k} = 0.47$  and  $\epsilon_{x_u^* z_k} = 0.08$ ). This indicates that the impact of general capital (non-OCM capital) on employment is increasingly positive with the skill level ( $\epsilon_{x_h^* z_k} > \epsilon_{x_s^* z_k} > \epsilon_{x_u^* z_k}$ ). This is consistent with a weaker form of the capital-skill complementarity hypothesis.

Furthermore, output elasticities for medium-skilled workers and unskilled workers are positive and significant with a higher output elasticity for unskilled workers than for medium-skilled workers ( $\epsilon_{x_s^* z_y} = 0.55 > \epsilon_{x_u^* z_y} = 0.43$ ). The demand for highly skilled workers, however, seem to be rather independent of changes in out-



put. Turning to the price elasticities of factor demand, we find that the own-price elasticities are significantly different from zero and negative, except for the own-wage elasticity of highly skilled workers.

For non-manufacturing industries, we also find a significantly positive impact of OCM capital on the employment of university graduates (see Table 8). The impact of OCM capital on medium-skilled workers is also positive and somewhat larger than the impact of OCM capital on highly skilled workers. Contrary to what is expected, we also find a large and positive effect of OCM capital on the demand for unskilled workers. Furthermore, an increase in general capital is reducing the demand for unskilled workers on the one hand and is increasing the demand for medium-skilled workers and highly skilled workers on the other hand. The elasticity of the employment of unskilled workers with respect to general capital is  $-0.32$  compared to the elasticity of general capital with respect to highly skilled workers and medium-skilled workers of about  $1.17$  and  $0.47$ , respectively (see Table 8). This is consistent with the hypothesis of capital-skill complementarity, which states that unskilled workers and capital are substitutes while skilled workers tend to be complements.

#### **Elasticities based on dynamic factor demand models**

Estimations results for the static factor demands presented above are partly hampered by serially correlated errors. This may suggest that the underlying static models are dynamically misspecified. We therefore present the long-run elasticities of the factor demand model based on dynamic factor demand models. The estimation period is 1979 –1994 because of the inclusion of variables in first differences. As expected, in all cases the LR-Test of the null hypothesis that the adjustment parameters are jointly equal to zero can be rejected. Table 9 shows the long-run elasticities of the partial error-correction model assuming a generalized Box-Cox functional form of the cost function for the manufacturing sector.

Again, we find a positive effect of OCM capital on any of the different types of labor. When looking at the static factor demand, this pattern also becomes apparent. The median elasticities of OCM capital with respect to highly skilled workers, medium skilled workers and unskilled workers are,  $0.11$ ,  $0.11$  and  $0.15$ , respectively. Again, we find evidence of capital-skill complementarity. The median elasticity of general capital with respect to university graduates is about  $0.80$  and highly significant. The impact of general capital on medium-skilled and unskilled workers is also positive but somewhat lower than the impact of general capital on university graduates.

Furthermore, we can see that material inputs can be substituted for both

Table 9: Long-run elasticities of the dynamic factor demand model, **manufacturing** (based on the PECM-BC)

$\epsilon_{x_i^*, p_j}$	$x_h^*$	$x_s^*$	$x_u^*$	$x_m^*$
	price elasticities			
$p_h$	0.09 (0.32)	-0.01 (-1.27)	-0.01 (-1.14)	0.00 (1.38)
$p_s$	-0.15 (-1.42)	-0.18 (-4.07)	-0.10 (-1.79)	0.02 (4.28)
$p_u$	-0.13 (-1.42)	-0.05 (-1.46)	-0.21 (-2.60)	0.02 (3.42)
$p_m$	0.13 (1.66)	0.22 (6.04)	0.32 (6.27)	-0.04 (-4.10)
$\epsilon_{x_i^*, z_j}$	capital, output and time elasticities			
$z_k$	0.80 (7.11)	0.43 (6.78)	0.23 (3.05)	0.61 (7.23)
$z_o$	0.11 (2.03)	0.11 (5.48)	0.15 (6.40)	0.11 (3.78)
$z_y$	0.07 (0.76)	0.15 (2.21)	0.31 (3.73)	-0.20 (-1.96)
$t$	0.021 (3.42)	-0.025 (-6.88)	-0.053 (-7.91)	-0.024 (-4.79)

Notes: The number of observations is 456. See Table 7.

unskilled workers and medium-skilled workers. In particular, the substitution possibilities are dominated by the substitutability between unskilled workers and materials. Own-wage elasticities for medium-skilled and unskilled workers are negative and significant.

For non-manufacturing industries, the results for the dynamic model appeared to be less satisfactory and are not reported here.

### **Sensitivity of the OCM elasticities with respect to the deflator of OCM investment**

Table 10 presents the elasticities of OCM capital with respect to the different skill levels based on different deflators for OCM investment for the manufacturing sector. Column one and two contain the OCM capital elasticities based on the French and German deflator of OCM investment. The most striking feature of Table 10 is that the impact of OCM capital on employment are somewhat sensitive with respect to the choice of the deflator of OCM investment. Particularly, the OCM effect is sensitive to the choice of the German deflator which is used to construct the OCM capital stock. As noted previously, the German price index

Table 10: Elasticities of employment with respect to OCM capital based on different deflators of OCM investment, **manufacturing** (obtained from the static Box-Cox)

OCM elasticities:	French deflator	German deflator
based on PECM		
$\epsilon_{x_h^* z_o}$	0.10 (4.64)	0.10 (3.10)
$\epsilon_{x_s^* z_o}$	0.08 (6.34)	0.10 (3.45)
$\epsilon_{x_u^* z_o}$	0.09 (4.66)	0.19 (3.98)
based on static factor demands		
$\epsilon_{x_h^* z_o}$	0.11 (3.12)	0.11 (2.20)
$\epsilon_{x_s^* z_o}$	0.02 (0.73)	0.02 (1.44)
$\epsilon_{x_u^* z_o}$	0.09 (3.39)	0.11 (2.91)

Notes: Median value of the elasticities evaluated at the midpoint data. t-values in parentheses.

for the OCM equipment may understate the true price decline.

Based on the French deflator the (long-run) elasticity of highly skilled workers with respect to OCM capital is 0.10 for the dynamic factor demand model and 0.11 for the static factor demand model. This indicates that between 62 and 68 percent of the observed increasing employment of university graduates can be explained by the increase in the OCM capital stock given the average growth rate of OCM capital stock across manufacturing industries about 22.4 percent per year. Based on the U.S. deflator, the elasticity of highly skilled workers with respect to the OCM capital stock is 0.10 for the dynamic factor demand model and 0.13 for the static factor demand model (see Table 7 and Table 9). Given the growth rate of the OCM capital stock based on the U.S. price index for OCAM plus photocopiers and related equipment (converted in local currency) of about 20.4 percent per year, between 62 and 74 percent of the expanding employment of highly skilled workers can be explained by the increase in the OCM capital stock. A comparison between both deflators shows that the OCM effect as well as the OCM elasticities based on the French deflator are quite similar to the OCM effect and elasticities based on the U.S. deflator (converted into a common currency).

The effects of the OCM capital stock on the employment change of university graduates are considerably lower when the German deflator is used to construct OCM capital stocks. Based on the German deflator for OCM investment, the elasticities of OCM capital with respect to highly skilled workers are 0.10 and 0.11 for the different specifications and are similar to the corresponding elasticities based on the French deflator. Given an increase in the OCM capital stock based on the German deflator of about 10 percent per year, between 34 and 37 percent of the observed expanding employment for university graduates can be attributed to the increase in the OCM capital stock. The results clearly indicate that impact of OCM capital is underestimated when the German price index for the OCM equipment is used to construct OCM capital stocks.

### Sources of employment change by skill level

Given the elasticities of factor demand, one can calculate how much of the observed change in employment can be attributed to the effects of prices, output, two types of capital and time. After a total differentiation of the labor demand equations and the following transformation into growth rates, the percentage change of employment of the different educational qualification levels can be written as:

$$\frac{\Delta x_{gnt}}{x_{gnt}} \simeq \sum_{j=h,s,u,m} \varepsilon_{x_g p_j} \frac{\Delta p_{jnt}}{p_{jnt}} + \sum_{i=k,o,y} \varepsilon_{x_g z_i} \frac{\Delta z_{int}}{z_{int}} + \varepsilon_{x_g t},$$

where  $\Delta x_{gnt}/x_{gnt}$  denotes the actual employment growth rate of the three types of labor ( $x_g = h, s, u$  for  $g = 1, 2, 3$ , respectively) which should be close to the predicted employment growth rate. The first term on the right-hand side captures the price effects calculated as the product of price changes and the estimated price elasticities; the second term on the right-hand side measures the impact of the two types of capital and the impact of output. The results of the decomposition analysis appear in Table 11. Both the observed and the predicted employment change are given in column one and two of Table 11. Column 3 to 7 contains the different sources of employment change in percent of the actual employment change. Column 8 contains the total predicted change as a percentage of actual change. In general, the predicted changes are relatively close to the observed ones. For instance, the average growth rate of the employment of highly skilled workers across manufacturing industries is about 3.6 percent which is close to the prediction of 3.8 percent for the static model and 4.1 for the dynamic model. Note that for this application the static factor demand model gives better predictions than the dynamic factor demand model. Therefore, the interpretation of results focuses on the sources of employment change obtained from the static model.

Table 11: Sources of employment change of university graduates and unskilled workers

types of worker	employment change per year		Sources in percent of <b>actual</b> change					
	ob- served	pre- dicted	price effect	out- put effect	general capital effect	OCM capital effect	time effect	to- tal
<b>manufacturing</b> , static BC, split sample								
highly skilled	3.6	3.8	0 <sup>a</sup>	0 <sup>a</sup>	11	72	22	104
unskilled	-3.9	-3.6	19	-15	-1	-73	161	91
<b>manufacturing</b> , PECM-BC								
highly skilled	3.6	4.1	-15	0	9	61	59	114
unskilled	-3.9	-2.5	19	-8	-2	-80	136	64
<b>non-manufacturing</b> , static BC								
highly skilled	5.0	4.4	22	0 <sup>a</sup>	54	34	-21	89
unskilled	-2.7	-2.3	110	-68	27	-131	146	84

Notes: <sup>a</sup>Insignificant elasticities are included.

For manufacturing industries, the main cause of the increase in the demand of highly skilled workers is the growing OCM capital stock. Here, 72 percent of the employment change of university graduates can be explained by computerization during the period 1978-1994. Using U.S. manufacturing data for the period 1959-1989, Morrison-Paul and Siegel (2001) find that the accumulation of high-tech capital has accounted for 9 percent of the expanding employment for college graduates for the period 1959-1989. The effect of general capital, however, is quite small. In manufacturing, the increase in general capital only explains 9 percent of the increasing employment of highly skilled workers.

In non-manufacturing industries, 34 percent of the observed employment change of highly skilled workers can be attributed to the increase in the OCM capital stock. For non-manufacturing, the effect of general capital on the demand for heterogeneous labor is more important than for manufacturing. Here, about 54 percent of the increase in employment of university graduates can be explained by the increase in general capital. Furthermore, 27 percent of the decreasing employment of unskilled workers can be explained by the increase in general capital.

Price and output effects play a minor role in explaining the employment change of highly skilled workers and medium-skilled workers. Wage effects and substitution effects between different types of labor and between labor and material

inputs, however, are more important in explaining the decreasing employment of unskilled workers. In the non-manufacturing sector, the wage and substitution effects between labor and material inputs are considerably more important than the effects of general capital in explaining the decreasing employment of unskilled workers.

## 5. Conclusions

The purpose of this paper has been to investigate the relationship between the increased growth of the OCM capital stock and the labor demand for different educational qualification groups. Static and dynamic factor demand models assuming a generalized Box-Cox, a generalized Leontief, a normalized quadratic and a translog functional form of the cost function are employed. This paper develops new estimates of the office machinery and computer (OCM) capital stock. U.S. price indices (adjusted for exchange rate changes) are used as deflators for OCM investment. Estimates using French and U.S. deflators for OCM investment imply that the growth in the German OCM capital stock based on the official OCM investment deflators is significantly underestimated by about 10 percentage points per year. We also examine the sensitivity of the key elasticities with respect to the deflator for OCM investment. Questions concerning sensitivity of the results with respect to the choice of the functional form were also addressed.

The empirical results indicate that the accumulation of the OCM capital stock is the major factor contributing to the shift in labor demand towards highly skilled workers. Accumulation of OCM capital accounts for between 60 and 71 percent of the expanding employment of university graduates in manufacturing industries between the period 1978-1994. In non-manufacturing industries, both OCM capital and general capital accounted for nearly all of the change in the employment of university graduates. Contrary to expectation, we also find a positive impact of the OCM capital stock on the demand for unskilled workers. Furthermore, accumulation of general capital tends to reduce unskilled workers. Wage effects and substitution effects between labor and material inputs play a minor role in explaining employment changes of highly skilled and medium-skilled workers, but these effects are more important in explaining the demand for unskilled workers. Finally, the results of the effects of the OCM capital stock are somewhat sensitive to the choice of the deflator of OCM investment which is used to construct the OCM capital stock. Estimates based on the German deflator significantly underestimate the effect of OCM capital on the employment of highly skilled workers.

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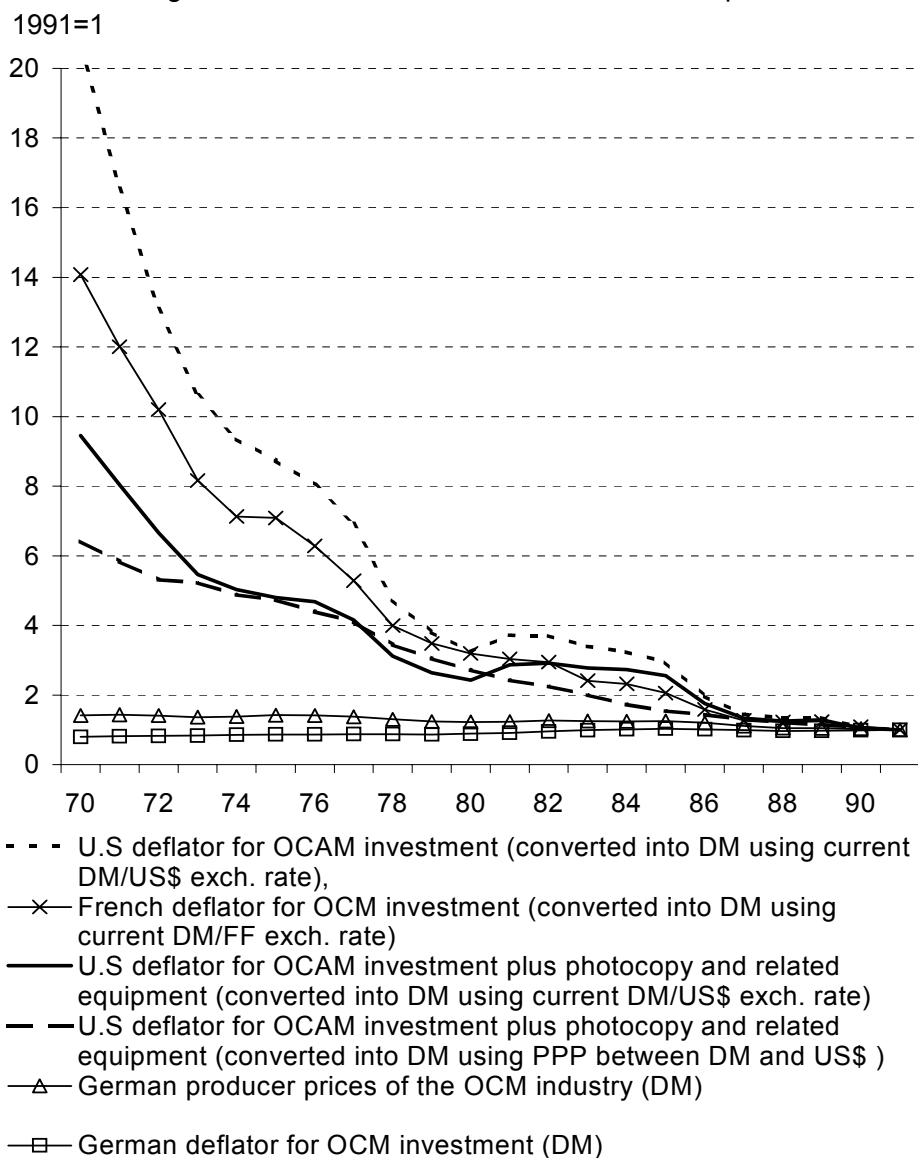
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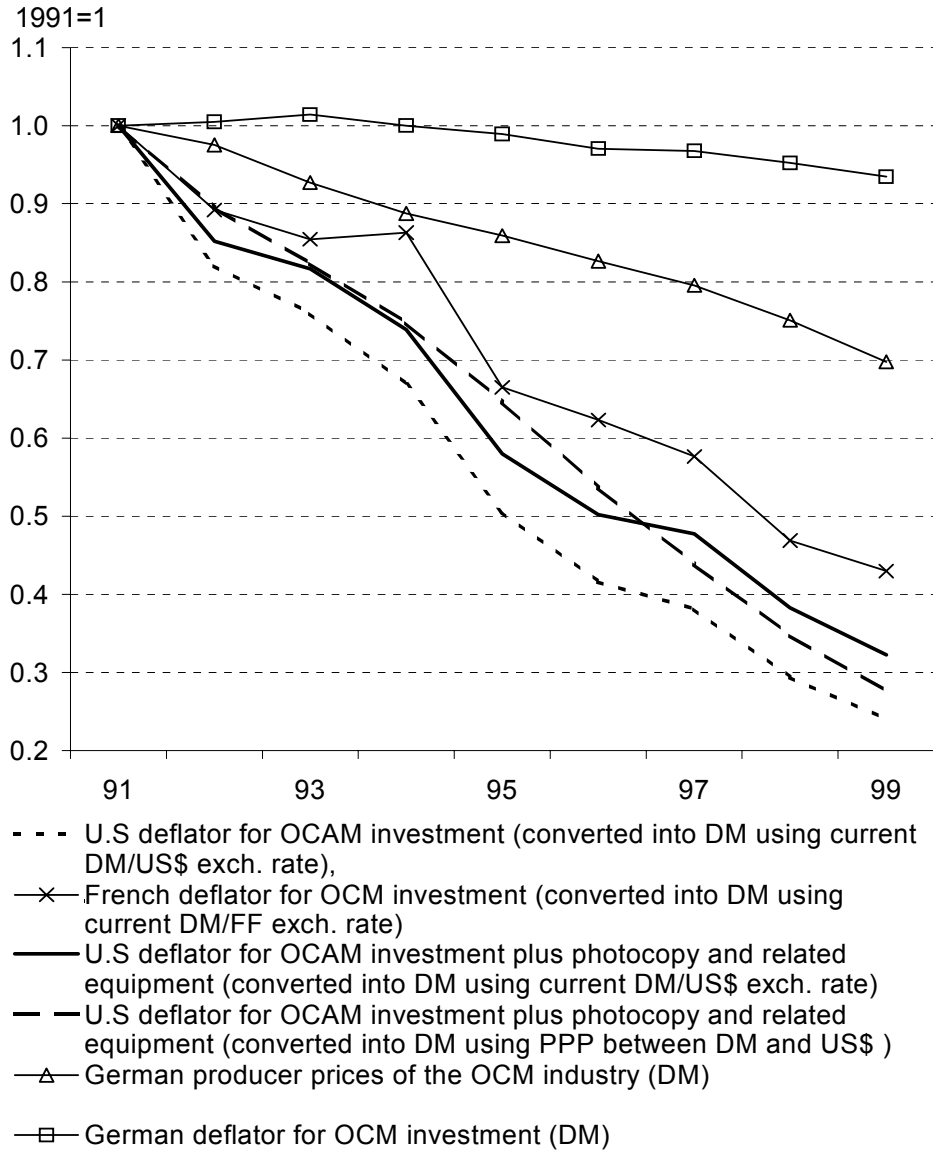
Figure 1: Deflators for OCM investment and output, 1970-1991



Notes: OCM denotes: office machinery and computers, OCAM denotes office computing (incl. peripheral equipment) and accounting equipment. PPP are Purchasing Power Parities for GDP.

Sources: U.S Bureau of Economic Analysis, NIPA Table 5.9, 5.8 and 7.8, INSEE, Statistical Office Germany, own calculations.

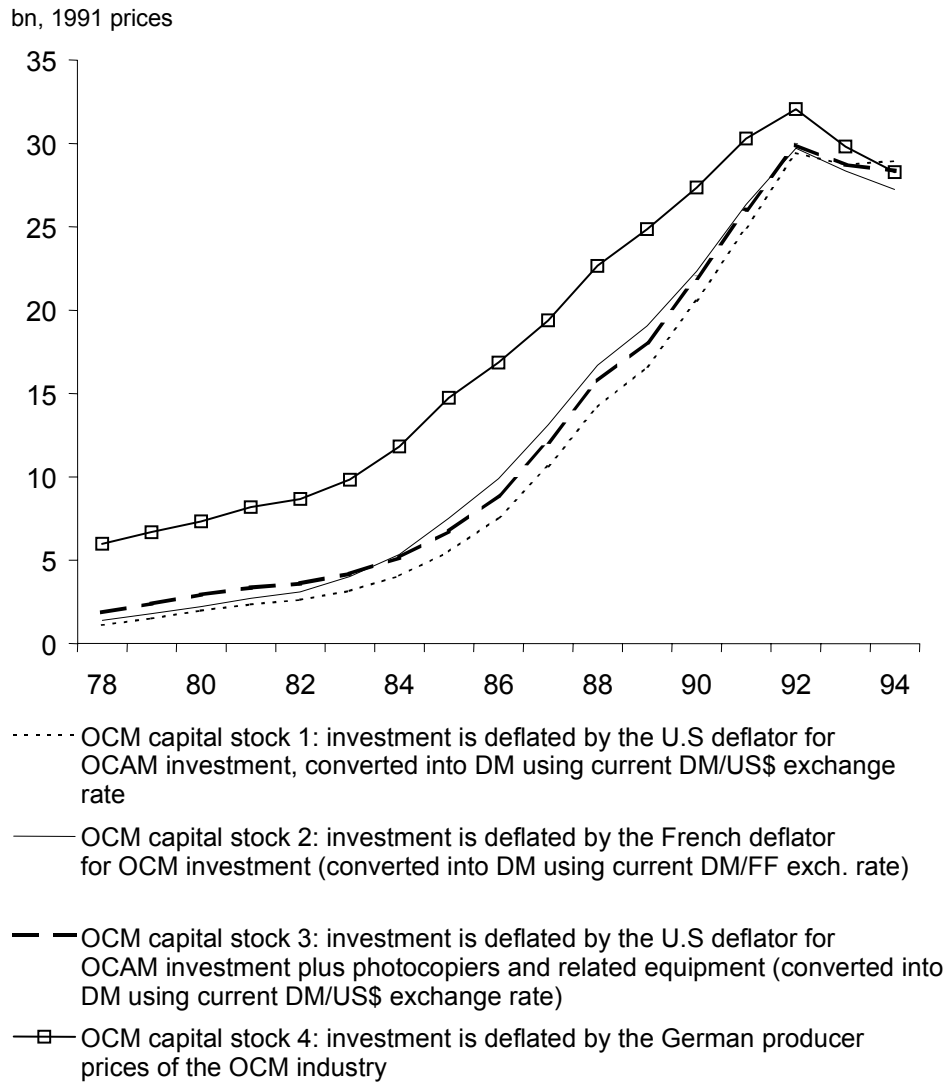
Figure 2: Deflators for OCM investment and output, 1970-1991



Notes: OCM denotes: office machinery and computers, OCAM denotes office computing (incl. peripheral equipment) and accounting equipment. PPP are Purchasing Power Parities for GDP.

Sources: U.S Bureau of Economic Analysis, NIPA Table 5.9, 5.8 and 7.8, INSEE, Statistical Office Germany, own calculations.

Figure 3: Evolution of the OCM capital stock in manufacturing



Notes: OCM capital stocks are estimated using PIM. Real investments were computed by dividing nominal investments by the price indices described above. The depreciation rate is 0.2729 between 1970 -1977 and 0.3119 between 1978 - 1994.

Figure 4: X-Y Scatterplot: OCM capital intensity and the skill intensity in 1994

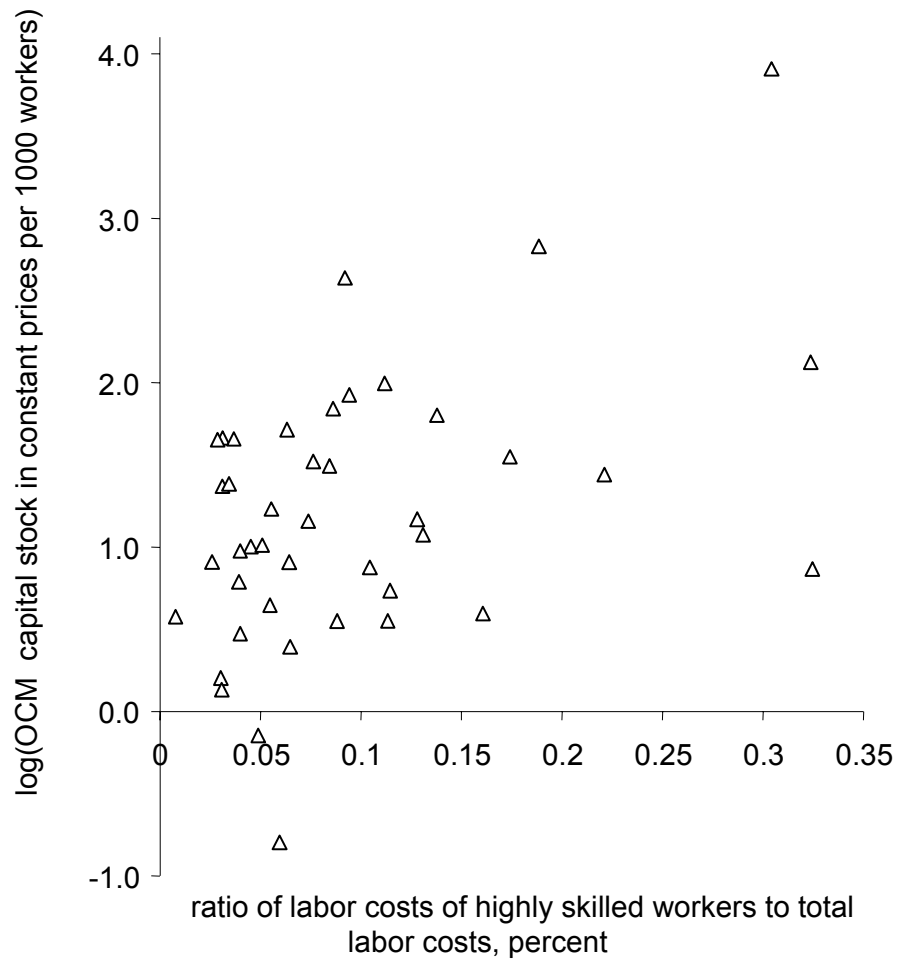


Table 12: Subcategories of OCM: office machinery

No.	title
3001 11 000	Automatic writing equipment and word-processing machines
3001 12 000	Typewriters, electric/ nonelectric
3001 13 200	Calculating machines
3001 13 300	Accounting machines
3001 13 500	Cash registers
3001 13 700	Mailing, letter handling & addressing machines, ticket-issuing machines
3001 14 303	Composite electronic circuit, components of mechanical writing equipment etc.
3001 14 305	Other parts & accessories of mechanical writing equipment and word processing machines
3001 14 503	Composite electronic circuit, components of calculating machines etc.
3001 14 505	Other parts and accessories of calculating machines, cash registers etc.
3001 21 500	Blueprinting machines
3001 21 700	Electrostatic photocopiers
3001 21 900	Other photocopiers excluding blueprinters, thermographic photocopiers
3001 22 000	Sheet-fed offset printing press for paper size $\leq 22 \times 36$ cm
3001 23 300	Duplicating machines
3001 23 500	Mailing, letter handling and addressing machines
3001 23 700	Coin-sorting, -counting and -wrapping machines
3001 23 901	Staplers
3001 23 903	Hole punches
3001 23 909	Other office machinery, excluding letter handling and addressing machines
3001 24 003	Composite electronic circuit, components of addressing machines etc.
3001 24 005	Other parts & accessories of addressing machines, coin-sorting machines etc.
3001 25 000	Parts and accessories of photocopiers
3001 90 000	Installation services of office machinery

Source: Statistical Office Germany, [www-zr.statistik-bund.de/dok/sgz6897.htm](http://www-zr.statistik-bund.de/dok/sgz6897.htm)

Table 13: Subcategories of OCM: computers

No.	title
3002 11 000	Automatic analogue or hybrid data-processing equipment
3002 12 030	Notebooks, laptops & other portable personal computers
3002 12 090	Desktop and other non-portable personal computers (PCs)
3002 13 000	Digital processing units
3002 14 300	Printers and plotters
3002 14 500	Computer keyboards
3002 14 730	Computer monitors
3002 14 760	Automatic cash dispensers
3002 14 770	Other digital self-service apparatus
3002 14 790	Other input/output units, e.g. scanners
3002 15 300	Central storage
3002 15 550	Disk storage devices (optical, magneto-optical)
3002 15 570	Other disk storage devices
3002 15 700	Magnetic tape storage devices
3002 15 900	Other storage devices
3002 16 000	Other data processing machinery, e.g. peripheral units
3002 17 003	Composite electronic circuit, components of ADP apparatus
3002 17 005	Other parts and accessories, ADP
3002 90 000	Installation of data processing machinery

Source: Statistical Office Germany. [www-zr.statistik-bund.de/dok/sgz6897.htm](http://www-zr.statistik-bund.de/dok/sgz6897.htm)

Table 14: Output (sales) composition of the office machinery and computer industry (nominal terms)

	1994	1996	1997	1998	1999
office machinery	11.5	13.5	14.5	13.3	6.6
computers	88.5	86.5	85.5	86.7	93.4

Source: Statistical Office Germany.