

Pollution, Abatement, and Sustainable Growth: A Schumpeterian Approach

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Abstract

This paper constructs a growth model that takes into account environmental concerns, and search for a difference in the pattern of environmental quality when technological progress is taken to be endogenous by extending Brock and Taylor (2003). Brock and Taylor define pollution production and abatement explicitly by considering pollution as an output of both production and abatement activities, and suggest a new approach to pollution convergence, which they name as the “Environmental Catch-up Hypothesis.” Their theoretical framework relies on AK production function where production increase depends significantly on capital increase. Since pollution is generated via production, analyzing capital stock as a source of pollution is necessary. This also raises attention to the types of capital such as physical and knowledge capital where the latter is cleaner compared to the former. Using a Schumpeterian framework, we include both of these two types of capital separately in the functional form. With this approach, it is possible to observe a sustainable balanced growth path increases with steadily improving technology. We also show that a rise in technological progress causes pollution growth to decline, and the Environmental Catch-up Hypothesis holds.

Preliminary and Incomplete

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1 Introduction

The interaction between economic growth and the environment is one of the fundamental issues for long term economic growth analysis. Indeed, this relationship has two dimensions which contradict each other. On one hand, as the economy grows, pollution is generated as a by-product of production which deteriorates the level of environmental quality. On the other hand, as the economy continues to grow, the resources for pollution abatement and environment-friendly technologies accrue which help reduce pollution stock and improve environmental quality (Butter and Hofkes, 1998). Accordingly, it is questionable whether economic growth and healthy environmental conditions will be compatible in the long run. This has been a challenge for the burgeoning literature on sustainable growth.

In this paper, what we mean by sustainability is continuous economic growth with non-declining environmental quality with the help of improving technological progress. This statement is significantly related with ecological modernization which asserts the possibility of reducing pollution by technological progress in production (Andersen and Massa, 2000). In other words, ecological modernization incorporates the innovation and diffusion of cleaner technologies that ensure decline in environmental intensity of each unit of output and while providing advantage for economic development.

To maintain sustainable growth considering environmental constraints has been a challenge since the 1970s. The earlier models incorporate the impacts of natural resource extraction within the neoclassical approach. (Brock and Taylor, 2004a) In these models, being the source of growth, technology is taken to be exogenous to the system. Within this realm, the Green Solow model (Brock and Taylor, 2004b) serves as a benchmark. In this model, Brock and Taylor augment the Solow model by incorporating technological progress in pollution abatement. They distinguish the impacts of technological progress in abatement and in goods production on environmental quality. While the technical progress in abatement leads to a technique effect, decreasing emissions, the technical progress in goods production leads to a scale effect, increasing emissions. However, taking technology as exogenous, this type of models could only "assume" growth as they do not take into account the endogenous progress in technology which is a major determinant in economic growth (Gradus and Smulders, 1993).

In the 1990s, economic growth models with endogenous technical progress became popular. Since technological innovation significantly determines the path of economic growth dynamics, endogenous growth models with evolving technological progress are characteristically more appropriate to examine sustainability (Aghion and Howitt, 1998). Indeed, in the context of sustainability, the effect of technological progress is twofold. On one hand, it is a threat to sustainability provided that it evolves in the direction of energy or resource using technologies. On the other hand, it is a solution when it is a progress through clean or resource-saving technologies. Consequently, in order to conjecture sustainability, the direction of technological improvement is needed to be analyzed (Bretscher and Smulders, 2007).

Combining this idea with environmental concerns, Smulders (1999) claims that permanent economic growth is attainable through continual knowledge accumulation without rising natural resource extraction and pollution generation. Using endogenous growth specifications, Hofkes (1996) contributes with a model which includes abatement activities. Among endogenous growth studies, Bovenberg and Smulders (1995) are the first that analyze pollution augmenting technological change in a two sector endogenous growth model.

Stokey (1998) uses both Cobb-Douglas and AK production technologies and adjusts them with an emission index that defines the techniques of production. She argues that since abatement and economic activity both use the same scarce resources, an increase in abatement intensity would result in a decline in economic growth. Therefore when abatement increases it decreases pollution stock both through technique and scale effects. In this model, Stokey uses the assumption of declining marginal utility of consumption in order to increase environmental quality. Accordingly, when the marginal utility of consumption declines, marginal disutility of environmental pollution relatively increases which raises the incentives for pollution abatement investments.

Using an AK production function, Brock and Taylor (2003) contribute to the literature in two fundamental ways. First, they define pollution production and abatement explicitly by considering pollution as an output of both production and abatement activities. Second, they suggest a new approach to convergence, which they dub as the “Environmental Catch-up Hypothesis.” For the first one, they argue that technological progress eliminates diminishing returns to both capital accumulation and abatement. They embrace zero emission technologies that enable pollution to be cleaned up when it is created. With technological progress, they challenge the assumption of rapidly declining marginal utility of consumption which is needed by Stokey (1998). With this assumption, it is possible for the ratio of investments in abatement to total investments to reach one in the limit. This is not plausible concerning the real data on abatement costs which stay as a small share of GDP (Brock and Taylor, 2004). Therefore, the way to match empirics and theory could be to assume technological progress in abatement in order to achieve sustainable growth. For the second contribution, Brock and Taylor (2003) introduce a new hypothesis which they call as the Environmental Catch-up. Accordingly, as income grows, the environmental quality deteriorates much more in initially poor countries compared to the rich ones. Additionally, as economic growth proceeds, the differences in their environmental quality narrow and converge to each other in the long run.

Despite the novel assumptions and innovations by Brock and Taylor (2003), the Kindergarten Rule model, the theoretical framework relies on a simple AK production function where production increase depends significantly on capital increase. Since pollution is generated via production, analyzing capital stock as a source of pollution is necessary which raises attention to the types of capital such as physical and knowledge capital where the latter is cleaner compared to the former. However constructing a one-sector endogenous growth model, Brock and Taylor (2003) and Stokey (1998) do not separate physical capital from knowledge capital and perceive capital as a single term. Therefore it is worthy to extend their model including those two types separately in the functional form. To do so, we add to the Kindergarten Rule Model of Brock and Taylor (2003) by incorporating endogenous technological change through the Schumpeterian approach. By this framework we also show an increase in the possibility of attaining sustainable growth. Furthermore, with the Schumpeterian framework, it is possible to avoid the potential unreasonable decline in consumption growth caused by the rise in abatement intensity inherent in the Kindergarten Rule model, by the offsetting role of the rise in technological progress.

Aghion and Howitt (1998) apply the Schumpeterian approach in structuring the capital stock and environmental quality stock equations distinguishing tangible capital goods (physical capital) from the intangible capital, technology. They modify Stokey’s (1998) model by introducing a Schumpeterian production function while holding the multiplicative measure of the dirtiness of techniques. In this paper, incorporating knowledge capital that grows with technological

progress, we add to the model of Brock and Taylor (2003) while keeping the abatement intensity framework the same. We develop an endogenous growth model similar to that of Aghion and Howitt (1998).

Different from the earlier models, such as Stokey (1998) and Aghion and Howitt (1998), in our model we do not specify a pollution index that adjusts the production function with the dirtiness of techniques. Instead, we adjust the production function with abatement intensity where an increase decreases the dirtiness of the production. In line with Brock and Taylor (2003), with the Schumpeterian approach, we search for differences in feasible and optimal sustainable growth conditions as well as Environmental Catch-up Hypothesis dynamics.

Our findings are as follows. We find conditions for feasible and optimal sustainable growth and the conditions for countries to switch to active abatement. In addition to the findings of Brock and Taylor (2003), we conclude that a rise in technological growth causes a decline in pollution growth. In contrast to the level effect in AK specification we find that the technological growth is effective to decrease pollution growth by this specification. In addition, empirically, we see that the ratio of R&D expenditures to GDP and the ratio of pollution to GDP for CO₂ are negatively related for thirteen of twenty OECD countries. However, we could not observe any relationship for abatement intensity and pollution for CO₂.

The rest of this thesis is organized as follows. In the second section, we describe and solve the model, and establish our results. The third section discusses the Environmental Catch-Up Hypothesis. Section four concludes. Proofs are provided in the appendices.

2 The Model

We use an infinitely lived representative agent model with the impatience factor of ρ and a constant elasticity of substitution utility function. Accordingly, the utility of the consumer increases with consumption, C , and decreases with the pollution stock, X . We also define a constant B as the impact of local pollution on an individual, considering the variables like population density and land size of the country that are effective in determination of the disutility of pollution stock. The resulting utility function is as follows:

$$U(C, X) = \frac{C^{1-\varepsilon}}{1-\varepsilon} - \frac{BX^\gamma}{\gamma} \quad (1)$$

where $\gamma \geq 1$ and $\varepsilon > 0$.

The gross output, Y , is assumed to be used either for investment, consumption or pollution abatement purposes. The factors of production are capital, K , and labor. T denotes the level of technology. Assuming that population does not grow, without loss of generality, normalize the amount of labor in the economy to 1. The labor force is divided into two, represented as L and n , where the latter is used in research activities and the former is used to produce the goods for consumption and investment. Incorporating the Schumpeterian framework of Aghion and Howitt (1998), we assume that the production of final output is done with labor and a continuum of distinct intermediate goods, M . The productivity levels of M are determined by $T(i)$ which indicates the quality of the intermediate good i . Hence the production function is

given by:

$$Y = L^{1-\alpha} \int_0^\infty T(i)M(i)^\alpha di \quad (2)$$

Intermediate goods are produced using $K(i)$ and $T(i)$ through the production function $M(i) = K(i)/T(i)$. The optimal amount of each M is found by maximizing $Y = L^{1-\alpha} \int_0^1 T(i)M(i)^\alpha di$ subject to $\int_0^1 T(i)M(i)di = K$. Writing the maximization problem yields:

$$\mathcal{L} = L^{1-\alpha} \int_0^1 T(i)M(i)^\alpha di - \lambda \left(\int_0^1 T(i)M(i)di - K \right) \quad (3)$$

Solving the first order condition and taking the derivative with respect to i , we obtain the following equation:

$$\alpha L^{1-\alpha} T(i)M(i)^{\alpha-1} = \lambda T(i) \quad (4)$$

Hence,

$$M(i) = L \left(\frac{\lambda}{\alpha} \right)^{\frac{1}{\alpha-1}} = M \quad (5)$$

Substituting M into $\int_0^1 T(i)M(i)di = K$ constraint we find $M \int_0^1 T(i)di = K$ where $\int_0^1 T(i) \equiv T$ is the average quality. Thus the optimal amount of each intermediate good is $M(i) = M = K/T$. Since $\int_0^1 T(i)M(i)^\alpha di = \int_0^1 T(i)M^\alpha di =$

$M^\alpha \int_0^1 T(i)di = M^\alpha T = (K/T)^\alpha T = K^\alpha T^{1-\alpha}$ Therefore the production function is:

$$Y = F(K, TL) = K^\alpha (T(1-n))^{1-\alpha} \quad (6)$$

Technology stock is determined through the Schumpeterian framework where we assume there is a leading edge technology being the maximum level of quality, $T(i)^{max}$ which is updated by each innovation generated by sector i . We also assume that the technological change is positively related with the maximum level of quality, $T(i)^{max}$, a positive rate, σ , that the innovations shifts the technological frontier of the economy and a positive parameter, η , that comes from a Poisson distribution and indicates the arrival rate of innovations to a single research worker, resulting in the following technological growth equation:

$$\dot{T} = \sigma \eta n T \quad (7)$$

We define the pollution stock, X , in the same manner as Brock and Taylor (2003) so that it increases with production and decreases with abatement and nature's constant regeneration ability factor, β . We define the economy's abatement intensity, θ , which is Y^A/Y where Y^A is the quantity of output used for pollution abatement. We illustrate abatement as an increasing and linearly homogeneous function, a that depends on Y and Y^A . Thus the pollution stock equation is:

$$\dot{X} = Y - a(Y, Y^A) - \beta X \quad (8)$$

In this paper, we specify pollution as local, since the pollution stock is determined through local drivers such as regional output and regeneration capacity. Indeed, if it was global pollution, pollution accumulation should depend on variables that capture the pollution that diffuses from other polluter countries, which do not exist in our specification.

Following Brock and Taylor (2003), we introduce an abatement technology, T^A , which raises the marginal productivity of abatement by augmenting total production, Y . When T^A is higher, greater level of pollution abatement is realized. T^A is assumed to be proportional to the average abatement intensity, θ , where the factor proportionality is taken to be 1. Therefore, if output allocated for abatement increases, the level of abatement technology increases by the same proportion. Hence, T^A is equal to θ which is defined to be Y^A/Y . Adjusting total output by pollution abatement technology, the pollution stock equation becomes:

$$\dot{X} = Y - a(YT^A, Y^A) - \beta X \quad (9)$$

Using the linear homogeneity property of the abatement function it is possible to write:

$$\dot{X} = Y(1 - T_A a(1, Y^A/YT_A)) - \beta X \quad (10)$$

Substituting the definition of abatement intensity gives us:

$$\dot{X} = Y(1 - T_A a(1, 1)) - \beta X \quad (11)$$

where $\theta = Y^A/Y = T_A$

As Brock and Taylor (2003) state, θ is less than or equal to $1/a$ since output increase causes rise in pollution stock (i.e. $(1 - \theta a(1, 1)) > 0$) and abatement decreases the pollution growth.

Given the structure of the model, the resource constraint of the economy is, therefore, given by:

$$\dot{K} = Y(1 - \theta) - \delta K - C \quad (12)$$

The social planner maximizes the lifetime utility of the representative household with a discount factor of ρ subject to the resource constraint and pollution accumulation. Hence, the problem is:

$$\max \int_0^\infty \left(\frac{C^{1-\varepsilon}}{1-\varepsilon} - \frac{BX^\gamma}{\gamma} \right) e^{-\rho t} dt \quad (13)$$

subject to

$$\dot{K} = K^\alpha (T(1-n))^{1-\alpha} (1-\theta) - \delta K - C \quad (14)$$

$$\dot{X} = K^\alpha (T(1-n))^{1-\alpha} (1-\theta a) - \beta X \quad (15)$$

$$\dot{T} = \sigma \eta n T \quad (16)$$

$$K(0) = K_0, X(0) = X_0, T(0) = T_0, \theta \leq 1/a \quad (17)$$

The current value Hamiltonian equation for this problem can be written as:

$$\rho W(K, X, T) = \max \left\{ H = \frac{C^{1-\varepsilon}}{1-\varepsilon} - \frac{BX^\gamma}{\gamma} + \lambda_1 [K^\alpha (T(1-n))^{1-\alpha} (1-\theta) - \delta K - C] \right. \\ \left. + \lambda_2 [K^\alpha (T(1-n))^{1-\alpha} (1-\theta a) - \beta X] + \lambda_3 [\sigma \eta n T] \right\} \quad (18)$$

where λ_1 is the positive shadow value of capital, λ_2 is the negative shadow cost of pollution and λ_3 is the positive shadow value of technology. The control variables are C , n and θ and the state variables are K , X and T . The first order conditions and the solution are in Appendix A.

In order to solve for the optimal level of abatement we focus on the terms including θ in the Hamiltonian. The simplified form of these are shown below:

$$\max \left\{ K^\alpha (T(1-n))^{1-\alpha} \theta [-\lambda_1 - a\lambda_2] \right\} \quad s.t. \quad 0 \leq \theta \leq 1/a \quad (19)$$

Following Brock and Taylor (2003) we define the term $S = -\lambda_1 - a\lambda_2$ and perform our analysis of the model under three different states: when S is positive, negative or zero. While $S > 0$, the shadow cost of pollution is higher than the shadow value of capital which leads to maximum abatement. On the contrary, while $S < 0$, the shadow value of capital is higher than the shadow cost of pollution which results in zero abatement. Lastly, while $S = 0$, the shadow cost of pollution and the shadow value of capital are equalized which conduces to active but not necessarily maximum abatement.

When $S > 0$, the abatement intensity, θ , is at its maximum level which is named as the Kindergarten Rule level by Brock and Taylor (2003), $\theta = \theta^K = 1/a$. In this state, the first order conditions lead to:

$$\begin{aligned} S &> 0 \\ \theta &= \theta^K = 1/a \\ \dot{\lambda}_1 &= [(\rho + \delta) - \alpha(1 - \theta^K) \frac{Y}{K}] \lambda_1 \\ \dot{\lambda}_2 &= (\rho + \beta) \lambda_2 + BX^{\gamma-1} \\ \dot{\lambda}_3 &= (\rho - \sigma \eta n) \lambda_3 - (1 - \alpha)(1 - 1/a) \frac{Y}{T} \lambda_1 \\ \dot{K} &= K^\alpha (T(1-n))^{1-\alpha} (1 - \theta^K) - \delta K - C, \quad K(0) = K_0 \\ \dot{X} &= K^\alpha (T(1-n))^{1-\alpha} (1 - \theta^K a) - \beta X, \quad X(0) = X_0 \\ \dot{T} &= \sigma \eta n T, \quad T(0) = T_0 \end{aligned} \quad (20)$$

When $S = 0$, θ is between 0 and its maximum level and the dynamics are as follows:

$$\begin{aligned} S &= 0 \\ 0 &\leq \theta \leq \theta^K = 1/a \\ \dot{\lambda}_1 &= [(\rho + \delta) - \alpha(1 - \theta^K) \frac{Y}{K}] \lambda_1 \\ \dot{\lambda}_2 &= (\rho + \beta) \lambda_2 + BX^{\gamma-1} \\ \dot{\lambda}_3 &= (\rho - \sigma \eta n) \lambda_3 - (1 - \alpha)(1 - 1/a) \frac{Y}{T} \lambda_1 \\ \dot{K} &= K^\alpha (T(1-n))^{1-\alpha} (1 - \theta) - \delta K - C, \quad K(0) = K_0 \\ \dot{X} &= K^\alpha (T(1-n))^{1-\alpha} (1 - \theta a) - \beta X, \quad X(0) = X_0 \\ \dot{T} &= \sigma \eta n T, \quad T(0) = T_0 \end{aligned} \quad (21)$$

When $S < 0$, θ is at its minimum level which leads to the dynamics:

$$\begin{aligned}
S &< 0 \\
\theta &= 0 \\
\dot{\lambda}_1 &= [(\rho + \delta) - \alpha \frac{Y}{K}] \lambda_1 - \alpha \lambda_2 \frac{Y}{K} \\
\dot{\lambda}_2 &= (\rho + \beta) \lambda_2 + B X^{\gamma-1} \\
\dot{\lambda}_3 &= (\rho - \sigma \eta n) \lambda_3 - (1 - \alpha)(1 - 1/a) \frac{Y}{T} \lambda_1 \\
\dot{K} &= K^\alpha (T(1 - n))^{1-\alpha} - \delta K - C, \quad K(0) = K_0 \\
\dot{X} &= K^\alpha (T(1 - n))^{1-\alpha} - \beta X, \quad X(0) = X_0 \\
\dot{T} &= \sigma \eta n T, \quad T(0) = T_0
\end{aligned} \tag{22}$$

With maximum abatement intensity, pollution is cleaned up at the same time as it is generated. In this case, the pollution stock decelerates due to the coefficient β , the regeneration capacity of nature. When abatement intensity is interior, pollution is partially abated and pollution stock is determined both by the abatement intensity and the regeneration coefficient. Without abatement, the pollution stock rises continuously with production and diminishes only with its own dynamics.

Capital accumulation and the shadow value of capital is also determined through the level of abatement intensity. Capital accumulation with abatement is less than that without abatement while some part of capital is allocated for abatement activities in the former. The shadow value of capital for active abatement case declines with a constant exponential rate given that $\alpha(1 - 1/a) \frac{Y}{K} > \rho + \delta$ which is shown in Appendix A.

$$\frac{\dot{\lambda}_1}{\lambda_1} = \rho + \delta - \alpha(1 - 1/a) \frac{Y}{K} < 0 \tag{23}$$

In all cases the technological growth is determined by its own dynamics where the shadow value of technology is partially linked to the shadow value of capital.

When abatement intensity is constant, the growth rates of capital, output, technology and consumption are found to be the same in the balanced growth path. Indeed, basically there are two possibilities for θ to be constant. The first one occurs when the abatement intensity is at its maximum level, where it is set to be a constant, θ^K . In this case the environment continuously improves as $\dot{X} = -\beta X$ and the growth paths are equalized at the balanced growth path which are shown below:

$$g_Y = g_K = g_T = g_C = \frac{\sigma \eta - \rho}{\varepsilon}, \quad g_X = -\beta < 0 \tag{24}$$

The second one occurs when θ is between zero and θ^K . In this case the dynamics could converge to the balanced growth path with equalized growth rates if θ becomes constant which could be attained in the limit when θ approaches to θ^K . In order to check whether this happens, as Brock and Taylor (2003) we define the deviation of θ from θ^K as follows:

$$D(\theta) = \frac{\theta^K - \theta}{\theta^K} \tag{25}$$

Substituting $D(\theta)$ to pollution accumulation equation we obtain:

$$\frac{\dot{X}}{X} = \frac{K^\alpha(T(1-n))^{1-\alpha}D(\theta)}{X} - \beta \quad (26)$$

With this formulation the growth rate of the pollution stock is determined through growth rates of capital, technology and $D(\theta)$. If the sum of these growth rates is less than zero, then pollution growth will be negative which can be shown as:

$$\alpha g_K + (1 - \alpha)g_T + g_D = g_X < 0 \quad (27)$$

In equation (27) the deceleration of g_D is substantial so that the convergence of θ to θ^K is very rapid. Thence, it more than offsets the growth in K and T which after all led the inequality to be satisfied.

In this set up, while pollution stock accumulates through production, it decays with the environment's ability to regenerate. The implications of this could be seen by analyzing $S = 0$ dynamics where rate of change of shadow cost of pollution must fall over time at the same rate the shadow value of capital falls over time. That could be written as:

$$\dot{\lambda}_1 = -a\dot{\lambda}_2 \quad (28)$$

Substituting $\dot{\lambda}_1$ and $\dot{\lambda}_2$ equations we end up with:

$$-\frac{1}{a} = \frac{BX^{\gamma-1}C^\varepsilon}{\rho - \beta - \alpha(1 - 1/a)\frac{Y}{K}} \quad (29)$$

Taking the derivative of both sides with respect to time we get the following negative growth rate:

$$\frac{\dot{X}}{X} = \frac{-\varepsilon}{\gamma - 1} \frac{\dot{C}}{C} = \frac{\rho - \sigma\eta}{\gamma - 1} < 0 \quad (30)$$

As can be seen in Appendix A, $\sigma\eta$ is the growth rate of technology. In equation (30) we find that increase in technological growth causes pollution growth to decrease.

In order to see the deviation dynamics of θ we rewrite equation (26) as:

$$D(\theta) = \frac{X}{K^\alpha(T(1-n))^{1-\alpha}} \left[\frac{\beta(\gamma - 1) - (\sigma\eta - \rho)}{(\gamma - 1)} \right] \quad (31)$$

$D(\theta)$ should be higher than or equal to zero where pollution and output should be positive which implies:

$$\beta(\gamma - 1) > \sigma\eta - \rho \quad (32)$$

This condition is satisfied if $\gamma \neq 1$ and β is adequately large relative to the term $\sigma\eta - \rho$. When we divide both sides of equation (32) by ε , the right hand side becomes the growth rate of output ($\frac{\beta(\gamma-1)}{\varepsilon} > \frac{\sigma\eta-\rho}{\varepsilon}$) which is shown in Appendix A. (Equation (93)). That signifies, when β is adequately large to satisfy this condition, then the balanced growth path could be

attained with high regeneration capacity of nature and relatively low output growth which we call the high regeneration-slow growth scenario. In this case since regeneration is active in pollution reduction, applying maximum abatement will not be necessary in the beginning of the growth process. As economy grows, abatement intensity approaches to its maximum value asymptotically. On the contrary if regeneration is limited ($\beta(\gamma - 1) < \sigma\eta - \rho$) then the balanced growth path could be satisfied with high level of abatement activities denoting that θ should be equal to θ^K .

Thus far we have analyzed the implications of active or maximum abatement cases where we search for reliable conditions for sustainable economic growth. In order to complete the statement we should also examine the scenario without abatement. When $\theta = 0$, the pollution accumulation equation becomes $\dot{X} = K^\alpha(T(1-n))^{1-\alpha} - \beta X$ where $\dot{X}$ stabilizes when the growth rates of output and pollution are equalized. ($g_x = g_Y > 0$). According to this condition, shadow cost of pollution rises steadily which in some point in time provides incentives for abatement. Furthermore, the shadow value of capital declines as the shadow cost of pollution increases (as λ_1 in equation (22) which again direct the process to active abatement. Consequently, a balanced growth path without abatement is not the optimal one. In sum, we have the following proposition.

Proposition 1. *Assuming $\sigma\eta - \rho > 0$, sustainable economic growth with continuously decreasing pollution stock is possible and optimal*

1. *When $\beta(\gamma - 1) > \sigma\eta - \rho$, abatement intensity approaches to its maximum level, θ^K , asymptotically.*
2. *When $\beta(\gamma - 1) < \sigma\eta - \rho$, abatement intensity is always equal to θ^K through the balanced growth path.*
3. *When abatement intensity is equal to zero, the balanced growth path we attained is not feasible.*

The proof of Proposition 1 is in Appendix B.

The necessary condition for sustainable growth, $\sigma\eta - \rho > 0$, is also the required condition for positive growth. Accordingly, $\sigma\eta$ is larger than ρ , which means technological growth is higher than the impatience factor. This means, research activity is sufficiently productive to prevent the solution with very low or without technological development which would end economic growth gradually in the future. Provided that the impatience factor is sufficiently high, economic growth would eventually cease, however that high impatience factor would not be chosen by a rational individual. As a result, this is a reasonable condition which is also a common requirement for Schumpeterian growth models (Aghion and Howitt, 1998).

When $\beta(\gamma - 1) < \sigma\eta - \rho$, in the fast growth-slow regeneration scenario, environmental degradation occurs. This could be attributed to the scale effect, as the environment deteriorates through the rise in economic activity. However, in our analysis, we offset this effect through introducing abatement intensity, the pollution abatement costs per output, which in the limit approaches to a positive constant, the Kindergarten Rule level. This brings about decline in the pollution stock which could be realized by allocating more output to abatement activities which triggers technological progress in abatement. Besides, after a certain income level, as composition and technique effects start to dominate, the environmental quality begins to improve. Hence,

the degradation occurred in the first stage might be stemmed from unavailable or nonexistent environment-friendly technologies.

Consequently, with this proposition, we show that when the abatement intensity is equal to θ^K , the sustainable balanced growth path is possible and optimal. In order to generate this result, Brock and Taylor (2003) need abatement intensity to be productive, noting that $1/a$ should not approach to 1. They do not specify the bounds of a , but only ascertain it to be higher than 1 for sustainable growth. However, this may lead us to incorrect results for consumption growth and therefore sustainability dynamics when the production function is in AK form. Accordingly, using the AK approach, we may not obtain a sustainable growth path. In order to show this, we analyze the consumption growth equation in the sustainable case of Brock and Taylor, that is:

$$\frac{\dot{C}}{C} = \frac{1}{\varepsilon} [A(1 - \theta^K) - \delta - \rho] > 0 \quad (33)$$

where $A(1 - \theta^K) > \delta + \rho$ for sustainable growth and $\theta^K = 1/a$. Considering $a > 1$, as a approaches to 1, we observe substantial declines in consumption growth. Therefore, the share of output allocated to abatement activities climbs to the level which would eventually reduce the share of output to be consumed and invested. This may cause consumption growth to decline sharply below the level needed for sustainable growth.

In our case, however, consumption growth is given by equation (63) as below (See Appendix A):

$$\frac{\dot{C}}{C} = \frac{1}{\varepsilon} \left[\alpha \left(1 - \frac{1}{a} \right) \frac{Y}{K} - \delta - \rho \right] > 0 \quad (34)$$

where obviously $\alpha \left(1 - \frac{1}{a} \right) \frac{Y}{K} = \alpha \left(1 - \frac{1}{a} \right) \left(\frac{TL}{K} \right)^{1-\alpha}$. This term can remain unchanged forever as the technological progress, T , grows faster than the capital, K , which would be able to offset the decline in the term $\left(1 - \frac{1}{a} \right)$. Therefore, inserting an ever improving endogenous technological change, the system is able to settle in a balanced growth path, offsetting any possible negative effect that might result from a rise in abatement intensity. This practically clarifies the reason to prefer the Schumpeterian approach in our analysis.

3 The Environmental Catch-Up Hypothesis

Our model is built upon the role and the magnitude of abatement intensity in order to curb pollution stock while technological progress counterbalances diminishing returns in production factors, and makes abatement more productive. In this context, in this section we will expand the Environmental Catch-up Hypothesis that was introduced by Brock and Taylor (2003).

Environmental Catch-up Hypothesis refers to the convergence of environmental quality between the rich and the poor countries at a point in time. It is highly related with the Environmental Kuznet's Curve (EKC) which relates rising per capita income with deteriorating environmental quality, while the relation is reversed after certain level of per capita income is reached (Barbier, 1997). In Environmental Catch-up Hypothesis, the poor country, C_p , is the one with lower initial capital stock whereas the rich country, C_R , corresponds to the one that

has higher initial capital stock. Except their initial capital stocks, both of these countries are identical and have a pristine environment in the beginning, which we name as Stage I. In this stage, while capital stock rises, pollution stock climbs, hence environmental quality degenerates. This pattern continues until the economy encounters to the switching locus and head to Stage II. In Stage II, while the capital stock continues to increase, pollution abatement activities are initiated and hence the pollution stock begins to decline. Therefore, the pollution stock levels of the poor and the rich countries initially diverge and then converge which generates the Environmental Catch-up Hypothesis (Brock and Taylor, 2003).

Initial divergence can be attributed to high abatement costs and high shadow price of capital for the poor country. In the first stage, the poor country features economic growth, production and consumption, and puts back environmental concerns. Hence, regeneration of the nature remains limited and environment degenerates abruptly in the poor country. In contrast, with lower shadow price of capital, and relatively lower abatement costs, natural regeneration in the rich country could be able to offset the pollution generated by production. Therefore, the environmental status in which the rich country switches to the second stage is better than the one in which the poor country switches. In this switching process, for both of the countries it is necessary to have the rate of return on capital to be lower or equal to the rate of return on pollution abatement.

Following Brock and Taylor (2003), we continue our analysis assuming that we are in fast growth-slow regeneration scenario, i.e. $\beta(\gamma - 1) < \sigma\eta - \rho$, where abatement intensity always equals to the Kindergarten Rule level. We next show the existence and the characteristics of the switching locus and Stage II.

The economy switches to Stage II when the shadow value of capital equals the shadow cost of pollution. After this point, as environmental costs exceeds the benefits from capital accumulation, it becomes reasonable to begin pollution abatement. In our analysis, this switching time is denoted as t^* and the levels of capital, pollution and technology at t^* are depicted as K^* , X^* , and T^* respectively. When these values are attained and equation (28) is satisfied, the economy reaches to the condition below:

$$\frac{\lambda_1(K^*X^*T^*)}{\lambda_2(K^*X^*T^*)} = a \quad (35)$$

At this point, marginal abatement costs equalized to marginal damage from pollution. When equation (35) is satisfied, while pollution decreases utility, it becomes rational to start abatement activities as in $S > 0$ dynamics. In order to find this starting point, the switching locus values, we need to solve λ_1^* and λ_2^* . For the shadow value of capital and the corresponding capital accumulation equation we have:

$$\lambda_1(t) = \lambda_1(t^*)e^{-gt} \quad (36)$$

$$K(t) = e^{-Mt} \left[e^{-Mt^*} K(t^*) + \lambda_1(0)^{-1/\varepsilon} \left(\frac{e^{(J+g/\varepsilon)t} - e^{(M+g/\varepsilon)t^*}}{M + g/\varepsilon} \right) \right] \quad (37)$$

where $J = \delta - \left(\frac{K(t)}{T(t)(1-n)} \right)^{\alpha-1}$ which is found to be a constant. To solve the value of $\lambda_1(t^*)$ we

apply the TVC of $\lim_{t \rightarrow \infty} \lambda_1(t)K(t)e^{-\rho t} = 0$. Substituting equation (36) and (37) we obtain:

$$\lim_{t \rightarrow \infty} e^{-\rho t} \lambda_1(t^*) e^{-gt} e^{-Jt} \left[e^{-Jt^*} K(t^*) + \lambda_1(0)^{-1/\varepsilon} \left(\frac{e^{(J+g/\varepsilon)t} - e^{(J+g/\varepsilon)t^*}}{J + g/\varepsilon} \right) \right] = 0 \quad (38)$$

Taking $t^* = 0$ for simplicity, we get:

$$\lim_{t \rightarrow \infty} e^{-(\rho+g+J)t} \lambda_1(0) \left[K(0) + \lambda_1(0)^{-1/\varepsilon} \left(\frac{e^{(J+g/\varepsilon)t} - 1}{J + g/\varepsilon} \right) \right] = 0 \quad (39)$$

where the sign of $(\rho + g + J)$ is negative and the sign of $J + g/\varepsilon$ should be negative for TVC to hold. Therefore λ_1^* is found to be:

$$\lambda_1(t^*) = [-K(t^*)(J + g/\varepsilon)]^{-\varepsilon} \quad (40)$$

Equation (40) indicates that the shadow value of capital is only determined by the capital stock. Accordingly, when economic growth is faster than the nature's regeneration capacity, the shadow value of capital declines which rationalizes the maximum abatement intensity.

For the shadow cost of pollution and pollution accumulation we have:

$$\lambda_2(t) = e^{(\beta+\rho)(t-t^*)} \left[\lambda_2(t^*) + BX(t^*)^{\gamma-1} \left[\frac{e^{\phi(t-t^*)} - 1}{-\phi} \right] \right] \quad (41)$$

$$X(t) = X(t^*)e^{-\beta(t-t^*)} \quad (42)$$

where $\phi = \rho + \gamma\beta$.

Invoking the TVC of $\lim_{t \rightarrow \infty} \lambda_2(t)X(t)e^{-\rho t} = 0$ and substituting equation (41) and (42) we end up with:

$$\lim_{t \rightarrow \infty} e^{-\rho t^*} X(t^*) \left[\lambda_2(t^*) + BX(t^*)^{\gamma-1} \left(\frac{e^{\phi(t-t^*)} - 1}{-\phi} \right) \right] = 0 \quad (43)$$

where we solve $\lambda_2(t^*)$ as:

$$\lambda_2(t^*) = -\frac{BX(t^*)^{\gamma-1}}{\rho + \gamma\beta} \quad (44)$$

Taking equations (36) and (44) and implementing equation (28) we obtain the switching locus formulation as follows:

$$MAC = \frac{1}{a} = \frac{BX^{*\gamma-1} [-K(t^*)(J + g/\varepsilon)]^\varepsilon}{\rho + \gamma\beta} = MD \quad (45)$$

where the left hand side of the equation represents the marginal abatement costs and the right hand side represents the marginal damage of pollution.

When $\gamma > 1$, as pollution stock rises, marginal damage increases. Moreover, income elasticity

of marginal damage is $\varepsilon\alpha > 0$. Higher values of ε and lower values of α lead to higher income effect. Additionally, lower α values also increases the factor share of technology in total production.

Whether every country reaches to the switching locus and passes to Stage II is still a question to be answered. Furthermore despite an economy without abatement is found to be non-optimal, we have to show that an economy that switches to Stage II, stays in Stage II forever.

Proposition 2. *Assuming that $\sigma\eta - \rho > 0$ and $\beta(\gamma - 1) < \sigma\eta - \rho$,*

1. *every economy that is in stage I must switch to Stage II in finite time.*
2. *every economy in Stage II stays there forever.*
3. *The switching point is where $MAC=MD$ as in equation (45)*

The proof of proposition 2 can be found in Appendix 2.

4 Conclusion

Whether the economic growth and environmental quality will be compatible in the long run is a challenging question for economists and ecologists as well as any other specialists that are interested in sustainable growth. In this thesis, we have tried to answer this question using the tools of endogenous growth theory.

Early attempts to model economic growth considering environmental quality have taken technological progress as exogenous. Since the technological progress is the determinant factor in output growth, this type of explanation will not be satisfactory in order to explain economic growth. Moreover, in the context of sustainability, technological progress has a large impact. First of all, as a proxy for knowledge capital, technology is a relatively cleaner factor of production compared to capital and secondly, it could help pollution abatement techniques to develop which would provide a better environmental quality. Therefore, taking technology as endogenous and specify its progress in detail would probably a better approach in order to analyze sustainability.

In this paper, we construct a growth model that takes into account environmental concerns, and search for a difference in the pattern of environmental quality when the technological progress is taken to be endogenous. We apply the Schumpeterian approach which was introduced by Aghion and Howitt (1998). In our analysis, we aim to discuss whether the rise in technological progress, abatement intensity and pollution abatement technologies would help to decrease pollution stock. We try to find the conditions for feasible and optimal balanced growth path. In order to check this we mainly follow the line of thought in the paper of Brock and Taylor (2003). Additionally we solve the Environmental Catch-up dynamics using the Schumpeterian framework.

We add to the paper of Brock and Taylor (2003) in two important ways. First, we replace the simple endogenous growth model (AK model) with the Schumpeterian growth specification. With this method, we become able to distinguish between the cleaner and dirtier factors of production where the former is technology and the latter is capital. Second, by this formulation we increase the possibility of attaining sustainable growth in the balanced growth path. In this context, the decline in consumption growth through the rise in abatement intensity can be offset by the rise in improving technological progress.

We find conditions for feasible and optimal sustainable growth and the conditions for countries to switch to active abatement. In addition to the findings of Brock and Taylor (2003), we conclude that the rise in technological growth causes decline in pollution growth. In contrast to the level effect in AK specification we find that the growth is effective to decrease pollution growth by this specification. Moreover, in the Environmental Catch-up formulation, we find the countries with higher technological progress are able to switch earlier to pollution abatement as technological progress quickens the fall in shadow value of capital.

APPENDICES

A The Solution of The Model

The current value Hamiltonian is:

$$\rho W(K, X, T) = \max \{ H = \frac{C^{1-\varepsilon}}{1-\varepsilon} - \frac{BX^\gamma}{\gamma} + \lambda_1 [K^\alpha (T(1-n))^{1-\alpha} (1-\theta) - \delta K - C] + \lambda_2 [K^\alpha (T(1-n))^{1-\alpha} (1-\theta a) - \beta X] + \lambda_3 [\sigma \eta n T] \} \quad (46)$$

The First order conditions are:

$$\frac{\partial H}{\partial C} = C^{-\varepsilon} - \lambda_1 = 0 \quad (47)$$

$$\frac{\partial H}{\partial \theta} = -(\lambda_1 + a\lambda_2) [K^\alpha (T(1-n))^{1-\alpha}] = 0 \quad (48)$$

$$\frac{\partial H}{\partial n} = (\alpha - 1) [\lambda_1 (1 - \theta) + \lambda_2 (1 - \theta a)] \frac{K^\alpha (T(1-n))^{1-\alpha}}{(1-n)} + \lambda_3 \sigma \eta T = 0 \quad (49)$$

$$\frac{\partial H}{\partial K} = \alpha [\lambda_1 (1 - \theta a) + \lambda_2 (1 - \theta a)] \frac{K^\alpha (T(1-n))^{1-\alpha}}{K} - \lambda_1 \delta = \rho \lambda_1 - \dot{\lambda}_1 \quad (50)$$

$$\frac{\partial H}{\partial X} = -BX^{\gamma-1} - \lambda_2 \beta = \rho \lambda_2 - \dot{\lambda}_2 \quad (51)$$

$$\frac{\partial H}{\partial T} = (1 - \alpha) [\lambda_1 (1 - \theta) + \lambda_2 (1 - \theta a)] \frac{K^\alpha (T(1-n))^{1-\alpha}}{T} + \lambda_3 \sigma \eta n = \rho \lambda_3 - \dot{\lambda}_3 \quad (52)$$

From equation 48

$$\lambda_1 = -a\lambda_2 \quad (53)$$

From equation 49

$$(1 - \alpha) [\lambda_1 (1 - \theta) + \lambda_2 (1 - \theta a)] \frac{Y}{1-n} = \lambda_3 \sigma \rho T \quad (54)$$

From equation 50, 51 and 52 respectively

$$\dot{\lambda}_1 = (\rho + \delta) \lambda_1 - \alpha [\lambda_1 (1 - \theta) + \lambda_2 (1 - \theta a)] \frac{Y}{K} \quad (55)$$

$$\dot{\lambda}_2 = (\rho + \beta) \lambda_2 + BX^{\gamma-1} \quad (56)$$

$$\dot{\lambda}_3 = (\rho - \sigma \eta n) \lambda_3 - (1 - \alpha) [\lambda_1 (1 - \theta) + \lambda_2 (1 - \theta a)] \frac{Y}{T} \quad (57)$$

where $\lambda_1 (1 - \theta) + \lambda_2 (1 - \theta a) = \lambda_1 (1 - 1/a) = \lambda_2 (1 - a)$ The transversality conditions are:

$$\begin{aligned} \lim_{t \rightarrow \infty} e^{-\rho t} \lambda_1(t) K(t) &= 0, \\ \lim_{t \rightarrow \infty} e^{-\rho t} \lambda_2(t) X(t) &= 0, \\ \lim_{t \rightarrow \infty} e^{-\rho t} \lambda_3(t) T(t) &= 0 \end{aligned} \quad (58)$$

From equation 55

$$\frac{\dot{\lambda}_1}{\lambda_1} = (\rho + \delta) - \alpha(1 - 1/a) \frac{Y}{K} \quad (59)$$

From equation 47

$$\begin{aligned} C^{-\varepsilon} &= \lambda_1 \\ \dot{\lambda}_1 &= -\varepsilon C^{-\varepsilon-1} \dot{\lambda}_1 \\ \frac{\dot{\lambda}_1}{\lambda_1} &= -\varepsilon \frac{\dot{C}}{C} \end{aligned} \quad (60)$$

Use equation 59 and 6014

$$\frac{\dot{C}}{C} = \frac{1}{\varepsilon} ((\alpha(1 - 1/a) \frac{Y}{K} - \rho - \delta)) \quad (61)$$

From equation 54

$$\begin{aligned} \lambda_1(1 - \alpha)(1 - 1/a) \frac{Y}{1 - n} &= \lambda_3 \sigma \eta T \\ \frac{(1 - \alpha)(1 - 1/a)}{1 - n} (\dot{Y} \lambda_1 + \dot{\lambda}_1 Y) &= \sigma \eta (\dot{\lambda}_3 T + \dot{T} \lambda_3) \\ \frac{(1 - \alpha)(1 - 1/a)}{1 - n} (\dot{Y} \lambda_1 - \varepsilon \lambda_1 \dot{\lambda}_Y) &= \sigma \eta T (\dot{\lambda}_3 + \sigma \eta \lambda_3) \end{aligned} \quad (62)$$

Substitute equation 60 and $\dot{T}$ equation

$$\frac{(1 - \alpha)(1 - 1/a)}{1 - n} \dot{Y} \lambda_1 (1 - \varepsilon) = \sigma \eta T (\dot{\lambda}_3 + \sigma \eta \lambda_3) \quad (63)$$

From equation 57

$$\dot{\lambda}_3 = (\rho - \sigma \eta n) \lambda_3 - (1 - \alpha)(1 - 1/a) \frac{Y}{T} \lambda_1 \quad (64)$$

$$\dot{\lambda}_3 + \sigma \eta n \lambda_3 = \rho \lambda_3 - (1 - \alpha)(1 - 1/a) \frac{Y}{T} \lambda_1 \quad (65)$$

Substitute equation 63 and divide by $\frac{(1-\alpha)(1-1/a)\lambda_1}{Y}$

$$\frac{\dot{Y}}{Y} = -\frac{1 - n}{1 - \varepsilon} \sigma \eta + \frac{\lambda_3 \sigma \eta T \rho (1 - n)}{(1 - \alpha)(1 - 1/a)(1 - \varepsilon) \lambda_1 Y} \quad (66)$$

$$g_n = 0 \quad (67)$$

$$g_K = g_Y = g_C \quad (68)$$

$$\frac{\dot{K}}{K} = (1 - \theta) \frac{Y}{K} - \frac{C}{K} - \delta \quad (69)$$

$$\frac{\dot{Y}}{Y} = \alpha \frac{\dot{K}}{K} + (1 - \alpha) \frac{\dot{T}}{T} + (1 - \alpha) \frac{\dot{n}}{n} \quad (70)$$

since $g_n = 0$

$$g_Y = \alpha g_K + (1 - \alpha) \sigma \eta n \quad (71)$$

Substitute equation 68 and divide both sides by $(1 - \alpha)$

$$g_Y = \sigma \eta n = g_T \quad (72)$$

From equation 53

$$\frac{\dot{\lambda}_1}{\lambda_1} = -a \frac{\dot{\lambda}_2}{\lambda_2} \quad (73)$$

Therefore $g_{\lambda_1} = g_{\lambda_2}$ and

$$-\varepsilon g_C = g_{\lambda_2} \quad (74)$$

From equation 56

$$g_{\lambda_2} = \frac{\dot{\lambda}_2}{\lambda_2} = \rho + \beta + \frac{BX^{(\gamma-1)}}{\lambda_2} \quad (75)$$

Differentiate with respect to time

$$0 = \frac{(\gamma - 1)BX^{(\gamma-2)}\dot{X}\lambda_2 - \dot{\lambda}_2 BX^{(\gamma-1)}}{\lambda_2^2} \quad (76)$$

$$(\gamma - 1) \frac{\dot{X}}{X} = \frac{\dot{\lambda}_2}{\lambda_2} \quad (77)$$

Differentiate equation 66 with respect to time and rearrange

$$0 = (\sigma \eta \rho (1 - n)(\dot{\lambda}_3 T + \dot{T} \lambda_3)(1 - \alpha)(1 - 1/a)(1 - \varepsilon) \lambda_1 Y \quad (78)$$

$$- \sigma \eta \rho (1 - n) \lambda_3 T (1 - \alpha)(1 - 1/a)(1 - \varepsilon)(\dot{\lambda}_1 Y + \dot{Y} \lambda_1))((1 - \alpha)(1 - 1/a)(1 - \varepsilon) \lambda_1 Y)^{-2} \quad (79)$$

$$\dot{\lambda}_3 + \sigma \eta n \lambda_3 = (1 - \varepsilon) \lambda_3 \frac{\dot{Y}}{Y} \quad (80)$$

$$\frac{\dot{\lambda}_3}{\lambda_3} + \sigma \eta n = (1 - \varepsilon) \frac{\dot{Y}}{Y} \quad (81)$$

$$g_{\lambda_3} + \sigma \eta n = (1 - \varepsilon) g_Y \quad (82)$$

From equation 54 and 57

$$\dot{\lambda}_3 = (\rho - \sigma\eta n)\lambda_3 - (1 - \alpha)\lambda_1(1 - 1/a)\frac{Y}{T} \quad (84)$$

$$\frac{\dot{\lambda}_3}{\lambda_3} = (\rho - \sigma\eta) = g_{\lambda_3} \quad (85)$$

From equation 57

$$\frac{\dot{\lambda}_3}{\lambda_3} = (\rho - \sigma\eta) - (1 - \alpha)(1 - 1/a)\frac{Y}{T}\frac{\lambda_1}{\lambda_3} \quad (86)$$

Differentiate the equation above with respect to time

$$0 = -(1 - \alpha)(1 - 1/a)\frac{(\dot{\lambda}_1 Y + \dot{Y}\lambda_1)(T\lambda_3) - (\dot{T}\lambda_3 + T\dot{\lambda}_3)\lambda_1 Y}{(\lambda_3 T)^2} \quad (87)$$

$$(\dot{\lambda}_1 Y + \dot{Y}\lambda_1)\lambda_3 T = (\dot{T}\lambda_3 + T\dot{\lambda}_3)\lambda_1 Y \quad (88)$$

$$\dot{Y}(1 - \varepsilon)\lambda_1\lambda_3 T = (\dot{T}\lambda_3 + T\dot{\lambda}_3)\lambda_1 Y \quad (89)$$

$$\frac{\dot{Y}}{Y}(1 - \varepsilon) = \frac{\dot{T}}{T} + \frac{\dot{\lambda}_3}{\lambda_3} \quad (90)$$

$$g_{\lambda_3} = g_Y(1 - \varepsilon) - g_T \quad (91)$$

From equation 72

$$g_{\lambda_3} = -\varepsilon g_Y = \rho - \sigma\eta \quad (92)$$

$$g_Y = \frac{\sigma\eta - \rho}{\varepsilon} \quad (93)$$

B Proof of Proposition 1

We show that the balanced growth path with positive capital, technology, output and consumption growth in the appendix. Now the optimality of these growth rates should be proved for (i) ($S = 0$) and (ii) ($S > 0$) for constant θ .

To prove (i) we write the pollution accumulation equation, $\dot{X} = K^\alpha(T(1 - n))^{1-\alpha}(1 - \theta a) - \beta X$, in terms of θ such as:

$$\theta = \frac{1}{a} \left(1 - \frac{X(0)e^{Nt}(N + \beta)}{Y} \right) \quad (94)$$

where we define $N = -(\sigma\eta - \rho)/(\gamma - 1)$.

Rewriting the capital accumulation equation we obtain:

$$\dot{K} = K^\alpha(T(1 - n))^{1-\alpha} \left(1 - \frac{1}{a} \left(1 - \frac{X(0)e^{Nt}(N + \beta)}{Y} \right) \right) - \delta K - C(t) \quad (95)$$

where $X(t) = X(0)e^{[(\rho-\sigma\eta)/(\gamma-1)]t}$ and $C(t) = C(0)e^{(N(1-\gamma)/\varepsilon)t}$.
Solving equation (95) we get:

$$K(t) = \pi_1 X(0)e^{Nt} - \pi_2 C(0)^{(N(1-\gamma)/\varepsilon)t} + \pi_3 e^{Ft} \quad (96)$$

As $\beta(\gamma - 1) > \sigma\eta - \rho$, $\pi_1 = \frac{(N+\beta)}{N-F} < 0$, $\pi_2 = \frac{1}{N(1-\gamma)/\varepsilon - F} = \frac{-\varepsilon}{\rho\varepsilon - g(1-\varepsilon)} < 0$ $F = \frac{Y}{K}(1 - \frac{1}{a}) - \delta$

The TVC is set to be $\lim_{t \rightarrow \infty} \lambda_1(t)K(t)e^{-\rho t} = 0$. Substituting $\lambda_1(t)$ and $K(t)$ we attain:

$$\lim_{t \rightarrow \infty} \lambda_1(0)e^{(\rho-\sigma\eta)t} e^{-\rho t} \left[\pi_1 X(0)e^{Nt} - \pi_2 C(0)^{(N(1-\gamma)/\varepsilon)t} + \pi_3 e^{Ft} \right] = 0 \quad (97)$$

The exponent of the first term goes to zero as $-\sigma\eta + N = -\sigma\eta + \frac{\rho-\sigma\eta}{1-\gamma} < 0$. For the second term to satisfy the TVC $-\sigma\eta + N(1-\gamma)/\varepsilon < 0$ should be met. Together with the balanced growth path solution this implies that $\sigma\eta(1-\varepsilon) < \rho < \sigma\eta$ which is consistent with the balanced growth path solution of $\lim_{t \rightarrow \infty} \lambda_3(t)T(t)e^{-\rho t} = 0$. The exponent of the third term is $-\sigma\eta + F = -\sigma\eta + \frac{Y}{K}(1 - \frac{1}{a}) - \delta$ which is higher than zero as $\frac{Y}{K}(1 - \frac{1}{a}) - \delta - \rho > 0$. Consequently π_3 should be zero for TVC to hold. Writing capital accumulation function again we get:

$$K(t) = e^{(N(1-\gamma)/\varepsilon)t} \left[\pi_1 X(0)e^{(N-N(1-\gamma)/\varepsilon)t} - \pi_2 C(t)e^{-(N(1-\gamma)/\varepsilon)t} \right] \quad (98)$$

Considering equation (98) in the limit, as time goes to infinity we observe that the exponent in front of the term $\pi_1 X(0)$ goes to zero since $N < 0$ and $K(t)$ converges to consumption i.e. the capital growth approaches to consumption growth ($\dot{K}(t) = \dot{C}(t)$).

This convergence is observed in the balanced growth path where the abatement intensity approaches to its maximum level, θ^K . In this process the magnitude of $N = -(\sigma\eta - \rho)/(\gamma - 1)$ is determinant for the speed of the convergence. That is as N increases in absolute value the speed of convergence increases. When $\sigma\eta - \rho$ is larger, technological growth is far larger than

the discount factor, meaning that as the technological growth increases the speed of convergence of θ to θ^K increases. When γ is larger, this means that the increase in pollution decreases utility

more than before which raises incentives to abate pollution quickly.

Lastly, the TVC, $\lim_{t \rightarrow \infty} \lambda_2(t)X(t)e^{-\rho t} = 0$ must be checked for the balanced growth path. To do, we solve the shadow value of pollution as:

$$\lambda_2(t) = \left[\lambda_2(0) + \frac{BX(0)^{\gamma-1}}{g + \rho + \beta} \left(1 - e^{-(g+\rho+\beta)t} \right) \right] e^{(\rho+\beta)t} \quad (99)$$

Substituting $\lambda_2(t)$ and $X(t)$ we obtain:

$$\lim_{t \rightarrow \infty} X(0) \left[\lambda_2(0) + \frac{BX(0)^{\gamma-1}}{g + \rho + \beta} \left(1 - e^{-(g+\rho+\beta)t} \right) \right] e^{[\beta+(\rho-\sigma\eta)/(\gamma-1)]t} = 0 \quad (100)$$

Since $\beta + (\rho - \sigma\eta)/(\gamma - 1) > 0$ in this case, the term multiplying $X(0)\lambda_2(0)$ goes to plus infinity. Therefore in order to satisfy the TVC the terms in brackets must be equal to zero in

the limit which in turn implies that:

$$\lambda_2(0) = -\frac{BX(0)^{\gamma-1}}{g + \rho + \beta} \quad (101)$$

This ends the proof of part (i). To prove part (ii) we assume $\beta(\gamma - 1) < \sigma\eta - \rho$ and show that $S > 0$ and $\theta = \theta^K$ dynamics as in equation (20) are relevant for this case. In the switching locus section we assumed the following in order to switch to the active abatement:

$$-a\lambda_2(t) > \lambda_1(t) \quad \forall t > t^s : \text{switching time} \quad (102)$$

For $S > 0$, the shadow value of capital and the shadow cost of pollution are found as:

$$\lambda_1(t) = \lambda_1(0)e^{-gt}, \quad \lambda_1(0) = [hK(0)]^{-\varepsilon} \quad \text{and} \quad h = -M - g/\varepsilon \quad (103)$$

$$\lambda_2(t) = \frac{-BX(0)^{\gamma-1}e^{\beta(1-\gamma)t}}{\rho + \gamma\beta} \quad (104)$$

Substituting $\lambda_1(t)$ and $\lambda_2(t)$ into 102 we obtain:

$$\frac{aBX(0)^{\gamma-1}e^{\beta(1-\gamma)t}}{\rho + \gamma\beta} > [hK(0)]^{-\varepsilon} e^{-gt} \quad \text{for } \forall t > t^s \quad (105)$$

When $t = t^s$, $\frac{aBX(0)^{\gamma-1}e^{\beta(1-\gamma)t}}{\rho + \gamma\beta} = [hK(0)]^{-\varepsilon} e^{-gt}$. If we multiply both sides by the switching locus equation we get: $1 > e^{[-g - \beta(1-\gamma)](t-t^s)}$

$$1 > e^{[-g - \beta(1-\gamma)](t-t^s)} \quad (106)$$

this condition is satisfied for $t > t^s$ if and only if $\beta(\gamma - 1) < g = \sigma\eta - \rho$ which is the assumption we made for the fast growth slow regeneration case. Since we are in the $S > 0$ zone and θ is always equal to θ^K .

For part (iii), we prove that a balanced growth path with no abatement is not possible. In this case the growth rate of pollution equal to the growth rate of output as $D(\theta) = 1$. The shadow value of pollution is equal to:

$$\lambda_2(t) = \lambda_2(0)e^{(\rho+\beta)t} + \frac{BX(0)^{\gamma-1}}{g + \rho + \beta}e^{(\rho+\beta)t} - \frac{BX(0)^{\gamma-1}}{g + \rho + \beta}e^{-gt} \quad (107)$$

The transversality condition can be written as:

$$\lim_{t \rightarrow \infty} X(0)e^{[(\rho - \sigma\eta)/(\gamma - 1)]t} \left[\lambda_2(0)e^{(\rho + \beta)t} + \frac{BX(0)^{\gamma-1}}{g + \rho + \beta}e^{(\rho + \beta)t} - \frac{BX(0)^{\gamma-1}}{g + \rho + \beta}e^{-gt} \right] e^{-\rho t} = 0 \quad (108)$$

The exponent of the term multiplying $\left(-\frac{BX(0)^{\gamma-1}}{g + \rho + \beta}\right)$ is $-g - \rho + (\rho - \sigma\eta)/(\gamma - 1) < 0$ as

$g = \sigma\eta - \rho > 0$. The TVC holds if we apply the condition of $\lambda_2(t) = -\frac{BX(0)^{\gamma-1}}{g + \rho + \beta}e^{-gt}$ which requires $\beta + (\rho - \sigma\eta)/(\gamma - 1) = 0$. Considering equation (107), the shadow cost of pollution decreases exponentially as time goes to infinity. In addition $X(t)$ declines exponentially as time evolves since $(\gamma - 1)g_x = g_{\lambda_2} = g_{\lambda_1} = -\varepsilon g_c = \rho - \sigma\eta = -g$. This creates a contradiction since as the shadow cost of pollution declines the incentives will be on the direction of positive pollution generation which in turn decreases the utility and at some point in time raises concerns for abatement. Therefore the balanced growth path without abatement is not optimal.

C Proof of Proposition 2

Part (ii) is proved in proof of proposition 1 and (iii) is shown in the text. In order to prove part (i) we will use a contradiction as Brock and Taylor do. We assume that it will not be optimal to leave stage I in finite time and $S < 0$ for all t meaning that:

$$0 \leq -a\lambda_2(t) < \lambda_1(t) \quad (109)$$

We bound $\lambda_1(t)$ from below and $\lambda_2(t)$ from above. While proving part (i) we will generate a contradiction that violates this condition. Since we assumed $S < 0$, the shadow value of capital should be as below:

$$\lambda_1(t) < \lambda_1(0)e^{-gt} \quad (110)$$

For $\lambda_2(t)$ we already have the following solution:

$$\lambda_2(t) = e^{(\rho + \eta)t} \left[\lambda_2(0) + \int_0^t BX(s)^{\gamma-1} e^{-(\rho + \eta)s} ds \right] \quad (111)$$

Using the TVC of $\lim_{t \rightarrow \infty} e^{-\rho t} \lambda_2(t) X(t) = 0$ we solve $\lambda_2(0)$ as:

$$\lambda_2(0) = -BX(0)^{\gamma-1} = - \int_0^\infty BX(s)^{\gamma-1} e^{-(\rho + \eta)s} ds \quad (112)$$

Together with equation (112), equation (111) becomes:

$$\lambda_2(t) = e^{(\rho+\eta)t} \left[- \int_t^\infty BX(s)^{\gamma-1} e^{-(\rho+\eta)s} ds \right] \quad (113)$$

The corresponding bounded pollution stock when $S < 0$ is:

$$X(t) \geq X(0)e^{-\eta t} \quad (114)$$

Substituting pollution stock equation into the solution of $\lambda_2(t)$ we obtain:

$$-\lambda_2(t) \geq -\lambda_2(t^*) = e^{(\rho+\eta)t} \left[\int_t^\infty BX(s)^{\gamma-1} e^{-(\rho+\eta)s} ds \right] \quad (115)$$

$$-\lambda_2(t^*) = e^{(-\eta(\gamma-1))t} \frac{BX(0)^{\gamma-1}}{\rho + \eta\gamma} \quad (116)$$

Now including the above solutions we rewrite equation (109) and get:

$$e^{(g-\eta(\gamma-1))t} \frac{aBX(0)^{\gamma-1}}{\rho + \eta\gamma} < \lambda_1(0) \quad (117)$$

which will not be satisfied for a sufficiently large t , since $\beta(\gamma - 1) < \sigma\eta - \rho = g$.

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