

Occupational choice and the quality of entrepreneurs[☆]

Eren Inci*

Sabanci University, Faculty of Arts and Social Sciences, Orhanli, Tuzla 34956, Istanbul, Turkey

ARTICLE INFO

Article history:

Received 1 April 2012
 Received in revised form 24 April 2013
 Accepted 26 April 2013
 Available online xxx

JEL classification:

D43
 D82
 H25
 L26

Keywords:

Entrepreneurship
 Entrepreneurial policy
 General equilibrium contract theory
 Occupational choice

ABSTRACT

This paper is the first to endogenize both risk-free interest and wage rates in a tractable occupational choice model. Individuals who differ in terms of entrepreneurial ability and wealth choose between entrepreneurship and wage-earning, and the wealth classes form endogenously. Because of the general equilibrium repercussions of policies, whether to tax or subsidize entrepreneurs depends crucially on the shape of the wealth distribution. In particular, a tax on entrepreneurs used to subsidize workers can sometimes increase the average quality of entrepreneurs. Unlike the previous studies, in all of which the risk-free interest rate is exogenous, the policy works by affecting the loan supply to the banks via swapping some low-ability upper-middle-class entrepreneurs with an equal number of high- and low-ability poor-class workers.

© 2013 Elsevier B.V. All rights reserved.

1. Introduction

It is already well known that entrepreneurship has an enormous effect on the performance of an economy. In most countries, this fact is commonly reflected in policy in the form of subsidies aimed at increasing the *number of entrepreneurs*. Yet, what guarantees that the individuals who become entrepreneurs as a result of these policies will be productive entrepreneurs rather than unproductive or even destructive ones? As is well-documented by Baumol (1990), Murphy et al. (1991) and de Mel et al. (2008), the misallocation of talent is a rather robust phenomenon across time and space. It is easy to make individuals entrepreneurs but difficult to find the good ones. Markets often prevent some high-ability individuals from pursuing entrepreneurship while they encourage some low-ability individuals to become entrepreneurs. How can the government increase the average quality of entrepreneurs, and thus improve welfare?

The previous literature addressing these questions goes in two directions (see Boadway and Tremblay, 2005; Parker, 2009, for broad surveys). The *overinvestment* literature shows that asymmetric information results in too many failures, thus

[☆] I am grateful to the session participants at the RICAPE2 Third Conference, the Cambridge-MIT Institute Workshop on Regional Innovation, the CEBR Conference on Entrepreneurship: Occupational Choice and Financing, the European Meeting of the Econometric Society, seminar participants at the University of Aberdeen, Bilkent University, Boston College, Boston University, the Center for European Economic Research (ZEW), Georgia Institute of Technology, Koc University, the Norwegian School of Economics and Business Administration, Sabanci University, the University of Mannheim, and David de Meza, Avinash Dixit, Nobuhiro Kiyotaki, William Neilson (*the editor*), Tomas Sjöström, Hi-Lin Tan, an anonymous associate editor, and two anonymous referees, especially Richard Arnott, Susanto Basu, and Andy Newman for helpful comments. This research is financially supported by the Paula and Daniel Greeley Award and the Boston College Dissertation Fellowship Award. Travel grants given by the NBER Entrepreneurship Group and the Cambridge-MIT Institute are also gratefully acknowledged. All errors are mine.

* Tel.: +90 216 483 9340; fax: +90 216 483 9250.

E-mail address: ereninci@sabanciuniv.edu

suggesting that taxing entrepreneurs may improve welfare (de Meza, 2002; de Meza and Webb, 1987, 1988, 1999, 2000; Ghatak et al., 2007; Parker, 2003). The *credit constraints* and the *underinvestment* literatures, on the other hand, argue that asymmetric information leads to credit rationing in the sense that entrepreneurs with socially efficient projects may not get sufficient funding, thus suggesting that subsidizing entrepreneurs may improve welfare. For example, Stiglitz and Weiss (1981) argue that lending interest rates can be inefficiently high, and if so, aggregate investment will be inefficiently low, which calls for a subsidy to entrepreneurs. Taxing entrepreneurs is never optimal in the class of models with *exogenous* credit constraints such as those in Banerjee and Newman (1993), Galor and Zeira (1993), Ghatak et al. (2001), Lloyd-Ellis and Bernhardt (2000), and Mookherjee and Ray (2003). All these papers assume an exogenous cost of capital (but see Gruner, 2003), but any policy that involves significant reallocation of individuals to capital-using occupations does affect the cost of capital. Hence, the modeling convenience of an exogenous risk-free interest rate then becomes an impediment to understanding the effects of policies.¹

To address this issue, I set up a simple occupational choice model in which there are two types, “high-type” and “low-type”, of agents who differ in terms of unobservable entrepreneurial abilities. Agents also differ with respect to their wealth. They face a decision of whether to become entrepreneurs or workers. There are two further links between entrepreneurship and wage-earning besides one being the outside option of the other. First, entrepreneurs hire workers. Second, the wealth endowments of the workers are lent to entrepreneurs in the financial markets. In the presence of such interlinkages in a general equilibrium setting, it becomes less clear *ex ante* whether creating incentives or disincentives in one occupation result in better outcomes in that occupation or economy-wide. I show that whether the government should tax or subsidize entrepreneurs depends on the fine details of the model such as the exact shape of the wealth distribution and relative scarcity of workers and entrepreneurs.² Second, whenever taxing entrepreneurs is optimal, the policy works by swapping some low-ability upper-middle-class entrepreneurs with an equal number of high- and low-ability poor-class workers and thus by increasing the loan supply to the banks. Therefore, the endogeneity of the interest rate is crucial in getting this result.

If agents decide to become entrepreneurs, they have to borrow from banks, since their wealth alone is not enough to fully finance their firms. Every agent has the same probability of success in entrepreneurship, but high-type agents may increase this probability by working hard. All loanable funds come from those who become workers. Thus, the number of entrepreneurs is simply the aggregate wealth available in the economy divided by the fixed capital requirement to start a firm. This implies that the number of entrepreneurs in the economy is fixed, which allows me to explore the effects of policies on the quality of the entrepreneurs alone. This means that excessive (or insufficient) lending is not an issue in this model. So, we would have efficiency in a de Meza and Webb (1987) kind of world. Here, however, because wealth differs among agents, this is not the case. The paper first derives the contracts offered by banks and analyzes the decisions of the agents in a partial equilibrium when the factor prices are given. The contractual structure endogenously forms four different wealth classes in the society: the poor, the lower-middle, the upper-middle, and the rich.

Banks have no choice but to offer pooling contracts to the poor and the lower-middle classes since it is always beneficial for low-type members of these wealth classes to mimic high-type agents. A pooling contract requires that high-type agents cross-subsidize low-type agents in the loan market. That only pooling contracts can be offered in these wealth classes affects the occupational structure in different ways. In the poor class, it distorts the occupational decisions downward by isolating high-type agents from the loan market and thus from entrepreneurship. The reason is that high-type agents in this class are so poor that they cannot both put effort into entrepreneurship and also cross-subsidize low-type agents in the loan market. Knowing this, banks set the interest rate high enough so that none of the agents in the poor class prefers to apply for loans. Hence, all poor-class agents, whether high- or low-type, become workers. However, in the lower-middle class, the pooling contracts distort occupational decisions upward by allowing the low-type agents to become entrepreneurs. On the one hand, high-type agents in this wealth class can put effort into entrepreneurship even though they have to cross-subsidize low-type agents; on the other hand, cross-subsidies make loans attractive to low-type agents. As a result, both high- and low-type agents prefer becoming entrepreneurs in the lower-middle class.

In the upper-middle wealth class, banks can offer separating contracts that “limit prices” the loans. Thus, low-type agents become workers and high-type agents become entrepreneurs in this wealth class. There is still cross-subsidization even though separating contracts are offered, but now it is in the form of information rents between the occupations. That is, the fact that the types cannot be observed causes transfers from high-type entrepreneurs to low-type workers. These information rents are efficient since they do not distort the occupational decisions and hence do not affect who can use the capital. Finally, rich low-type agents need to borrow much less to start their firms, and thus, they do not benefit much from

¹ Even for small open economies, the occupational decisions of agents can affect factor prices, owing to imperfect financial markets and limited lending to any specific country. Despite the globalization movements in recent decades, the Feldstein and Horioka Puzzle (1980) – which presents the empirical regularity that the long-run average of national savings is highly correlated to domestic investment – remains one of the six major puzzles in international macroeconomics (Obstfeld and Rogoff, 2000).

² A related strand of literature in the economics of entrepreneurship questions whether providing incentives for various activities of entrepreneurs works. Process innovation made by entrepreneurs is one example. Inci (2009) shows that whether to subsidize or tax R&D activities of entrepreneurs crucially depends on the degree of technological spillovers and the number of firms in the industry. Networking activities of entrepreneurs are another example. Bac and Inci (2010) show that networking activities of entrepreneurs may result in a lower number of high-type entrepreneurs in some equilibria even when the network is not nepotistic in any sense. Inci and Parker (2013) show that entrepreneurs may expend resources to become network members for purely redistributive private gains as network members.

Download English Version:

<https://daneshyari.com/en/article/7243744>

Download Persian Version:

<https://daneshyari.com/article/7243744>

[Daneshyari.com](https://daneshyari.com)