

Discussion of

Optimal Development Policies with Financial Frictions

(Itskhoki and Moll)

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- The authors ask a classic question in economics:
 - What are the optimal policy instruments for accelerating growth?
- The bottlenecks to growth are
 - A scarcity of *entrepreneurial* wealth (limits the use of capital in production)
 - A misallocation of this wealth

- First generation of growth models (one or two sector)
 - General scarcity of capital
 - Policy prescriptions: foreign aid, state run enterprises, consumption suppression.

- Second Generation models
 - Productivity differences across countries (misallocation)
 - Policy prescriptions: education, R&D, remove impediments to competition

- This paper:
 - What (limited) tax and transfer policies increase entrepreneurial resources?
 - Growth reduces misallocation.

SETUP

- Consumer problem is standard

$$\max_{\{c_t, l_t\}} \sum_{t=0}^{\infty} \left(\frac{1}{1 + \rho} \right)^t u(c_t, l_t)$$

subject to

$$c_t + b_{t+1} = w_t l_t + (1 + r^*) b_t$$

- Entrepreneurs face a collateral constraint

$$\max_{\{c_t^e, n_t, k_t\}} \sum_{t=0}^{\infty} \left(\frac{1}{1+\delta} \right)^t \log c_t^e$$

subject to

$$c_t^e + a_{t+1} = \pi(a_t, z_t) + (1+r^*)a_t$$

$$\pi(a_t, z_t) = \max \left\{ 0, \max_{n_t, k_t} \left(A_t (z_t k_t)^\alpha n_t^{1-\alpha} - w_t n_t - r^* k_t \right) \right\}$$

$$k_t \leq \lambda a_t$$

- Profits are linear in k_t (CRS)

- Constrained by entrepreneurial wealth

$$\pi(a_t, z_t) = \left(\alpha A_t^{1/\alpha} z_t \left(\frac{1-\alpha}{w_t} \right)^{\frac{1-\alpha}{\alpha}} - r^* \right) \lambda a$$

- Rates of return are not equalized across all agents

$$MP_K = \alpha A_t^{1/\alpha} z_t \left(\frac{1-\alpha}{w_t} \right)^{\frac{1-\alpha}{\alpha}} \geq r^*$$

- How should a planner transfer resources from consumers to entrepreneurs?
- Limited set of policy instruments
 - Proportional taxes/subsidy on worker income and savings
 - Lump sum tax/subsidy for entrepreneurs and workers
- Policy instruments are designed to be “simple”
 - Not conditioned on unobservables
 - No redistribution across entrepreneurs or households (identical)
 - Not controlling quantities of inputs/outputs directly

Key insights for a poor economy:

- If entrepreneurs can be directly subsidized
 - Optimal policy is a lump sum tax from workers to entrepreneurs which gets to steady state immediately
- If subsidies are not possible
 - Optimal policy to transfer resources to entrepreneurs is a labor subsidy (leisure tax).

- Labor subsidy shifts out the labor supply curve, lowers wages
 - increases output, profits and entrepreneurial wealth.
 - Financed by a lump sum tax
- Compensate workers by reversing the subsidy to a tax (subsidising leisure) when the economy is richer
 - Raises wages, increases leisure.
 - Steady state has positive labor taxes

- Capital income subsidies are of no (or limited) use
 - Entrepreneurs cannot access consumer savings
 - No reason to distort intertemporal consumption saving margin

- Rich and tractable framework to study optimal policy
 - Some assumptions necessary for tractability: CRS, linear savings rules for entrepreneurs, linear collateral constraint, i.i.d. productivity of entrepreneurs.
- Would be interesting to calibrate this model to see if it delivers plausible optimal policies
- A more general model would probably yield similar results

- Focus on “implementable” taxes and subsidies
 - But they are still quite sophisticated.
- Need a tax collection and reporting system (expensive)
- Heterogeneity across consumers
 - Lump sum tax and proportional subsidy could be very regressive
- Liquidity constraint which is the source of the inefficiency
 - Easing this would probably give more bang for the buck