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

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

subject to

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

• Entrepreneurs face a collateral constraint

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

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

$$\pi\left(a_{t}, z_{t}\right) = \left(\alpha A_{t}^{1/\alpha} z_{t} \left(\frac{1-\alpha}{w_{t}}\right)^{\frac{1-\alpha}{\alpha}} - r^{*}\right) \lambda a$$

- Rates of return are not equalized across all agents

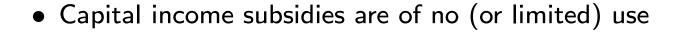
$$MP_K = \alpha A_t^{1/\alpha} z_t \left(\frac{1-\alpha}{w_t}\right)^{\frac{1-\alpha}{\alpha}} \geqslant r^*$$

- 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 desiged 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



- 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