

Active Labor Market Policies in General Equilibrium: Crowd-In or Crowd-Out?

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Abstract

Recent empirical work has shown that high search costs may contribute to the low levels of wage work in many developing countries. This paper studies the aggregate effects of job search subsidy aimed at increasing participation in the wage labor market using a model of heterogeneous household who choose between participation in the wage sector and “subsistence self employment” and heterogeneous entrepreneurs with varied productivities. I identify four key general equilibrium channels. Congestion and capital-labor ratio reductions crowd out additional participation relative to a partial equilibrium benchmark (i.e the effect estimated experimentally) while expansions in hiring and improvements in allocative efficiency (boosting TFP and average wages) crowd in participation. I quantify the model using weekly data on individuals’ search behavior and validate the model by showing that it accurately predicts the results of an experimental evaluation of labor search subsidies. The estimated model predicts the crowd-out effects dominate and the aggregate impact of such a policy is smaller than an experiment would suggest. The increase in TFP dominates the reduction in capital-labor ratios and average pre-tax wages increase by 1.9 percent, although funding the policy requires a 2.4 percent tax increase. Still, the policy increases average welfare by 0.6 percent. These results suggest that although congestion limits ability of subsidies alone to expand the wage sector in aggregate, policies targeting at reducing labor market frictions and increasing hiring could substantially increase wages and productivity.

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1. Introduction

It is well established that the reallocation of labor from self-employment to wage work is a crucial aspect of structural change and economic development. For example, [Gollin \(2008\)](#) documents a substantial cross-country relationship between income and self-employment rates where low-income countries have substantially higher rates of self-employment. [Poschke \(2019\)](#) shows that this relationship continues to hold even when looking at only urban workers, suggesting that it is not merely the result of cross-country differences in agricultural share. Furthermore, while some self-employed individuals may be successful entrepreneurs, there is widespread belief that many of the self-employed in poor countries are unproductive entrepreneurs choosing self-employment out of necessity, sometimes referred to as “subsistence self-employment” ([Schoar 2010](#), [Herreño & Ocampo 2021](#)). This notion is further reinforced by the fact that a large fraction of self-employed individuals in poor countries report turning to self-employment due to a lack of other employment opportunities ([Poschke 2013](#)).

The observation that there are high levels of self-employment and little wage work has inspired policymakers in developing countries to implement Active Labor Market Policies (ALMPs) aimed at encouraging and assisting workers’ participation in the labor market for wage jobs. These policies cover a wide variety of interventions including explicit subsidies for job seekers, free or subsidized vocational training or apprenticeship, job fairs, or algorithm-made matches between workers and jobs. As the popularity of such policies has grown, economists have begun to evaluate their effects experimentally. For example, [Abebe, Caria, Fafchamps, Falco, Franklin & Quinn \(2021\)](#), [Caria, Gordon, Kasy, Quinn, Shami & Teytelboym \(2020\)](#); and [Franklin \(2018\)](#) evaluate the effects of providing explicit subsidies to job searchers through conditional cash transfers, unconditional cash transfers, and transportation subsidies respectively. These policies are primarily motivated by the observation that many individuals searching for jobs have little to no savings and face fairly high costs of searching for jobs (which is performed in-person in many developing countries). A search subsidy can help overcome this barrier and allow workers to find jobs in the wage sector. Other policies include various vocational training and apprenticeship programs (evaluated in [Alfonsi, Bandiera, Bassi, Burgess, Rasul, Sulaiman & Vitali 2020](#), [Bratti, Ghirelli, Havari & Santangelo 2018](#), [Bandiera, Bassi, Burgess, Rasul, Sulaiman & Vitali 2021](#), [Crépon & Premand 2018](#)) and explicit hiring subsidies (as in [Algan, Crépon & Glover 2020](#)).

motivated by the fact that many firms self-report difficulties in finding reliable workers.

In this paper, I evaluate the effects of a particular ALMP, a subsidy for job searchers, in general equilibrium. I build a macroeconomic model of entrepreneurs, workers, and labor search in developing countries. Workers face a choice between engaging in self-employment or participating in the labor market for wage work (as in [Herreño & Ocampo 2021](#), [Poschke 2019](#)). Workers experience idiosyncratic productivity shocks in self-employment and face incomplete markets in the spirit of [Aiyagari \(1994\)](#), creating an incentive for self-insurance. To participate in the wage sector, workers must first pay a search cost to find a job. Workers face idiosyncratic job-finding risk; paying the search cost may or may not lead to a job at the end of the period. Combined with incomplete markets, this job-finding risk induces workers to ensure that they are sufficiently self-insured before they attempt to search for a job and, if they are unlucky and fail to find one for a few periods, they will return to self-employment. Firms are run by heterogeneously productive entrepreneurs who face a financial friction in the form of a collateral constraint that restricts their choice of capital (as in [Itskhoki & Moll 2019](#), [Buera, Kaboski & Shin 2021](#)). To overcome this friction, entrepreneurs accumulate collateral by reinvesting a portion of their profits each period, allowing them to continue to grow. Entrepreneurs hire workers in the frictional labor market by posting costly vacancies. Paying vacancy costs reduces entrepreneur profits and thus reduces their ability to grow through reinvestment each period.

The justification for job search subsidies is immediately apparent. Although wage work is, on average, more productive than self-employment, workers are unable to insure against job-finding risk and, as a result, poor workers will opt for the safety of self-employment, despite the fact that it is less productive. A job search subsidy can encourage participation in the labor market and provide insurance against the risk that an individual may not find a job.

I identify four key general equilibrium channels that serve to either dampen or enhance the impact of subsidies. The first two channels are fairly typical and serve to crowd out participation in the labor market (relative to what we expect in partial equilibrium. That is, the effect an experiment would estimate). A search subsidy naturally increases the number of households who search for a job, reducing labor market tightness. In a search-and-matching framework, this leads to both a reduction the probability that any particular household is matched

with a job (congestion). Additionally, it reduces the hiring costs for entrepreneurs leading to a lower capital-labor ratio and lower wages. Both effects serve to lower the expected benefits of searching and push marginal household out of the wage sector and into self employment.

More interesting are the remaining two effects that act to crowd in labor market participation. Entrepreneurs respond to the reduction in hiring costs described above by increasing their growth rates as their profits increase. Because hiring costs represent a larger portion of total costs for more productive entrepreneurs, there entrepreneurs experience larger increases in their grow rates. As a result, the share of capital and labor commanded by high productivity entrepreneurs slowly increases in response to the policy, improving allocative efficiency, total factor productivity, and (because productive entrepreneurs pay a wage premium) average wages, leading to crowd-in.

The final effect occurs as a result of the fact that bargained wages do not fully reflect the marginal product of a worker. Instead, a share of a workers output is capture by the entrepreneur and retained as profits which are then split between entrepreneur consumption, financing capital, and hiring workers for the next period. In this sense, the output of a searcher who becomes a worker is used to finance the hiring of future workers.

I estimate the model using the simulated method of moments to match the results of an experiment in Addis Ababa, Ethiopia performed by [Abebe et al. \(2021\)](#). The experiment offered cash subsidies to job seekers in the city center and was designed to operate as a conditional cash transfer; that is, treated individuals only received the subsidy if they spent the day looking for work. I estimate the model to match the observed increase in search behavior and wage employment as a result of the subsidy as well as some data moments from the control arm of the experiment, such as the average savings held by job searchers and the average job-finding rate. In addition to data from this experiment, I also estimate the model to match typical macro aggregates for Ethiopia as well as firm-level moments calculated using the World Bank Enterprise Survey for Addis Ababa.

Using the estimated model, I evaluate the effects of implementing an economy-wide labor search subsidy funded by a tax on wage workers. Overall, I find that the policy is successful in moving workers out of the traditional sector; however, the crowd-out effects dominate and substantially limit the policy's effectiveness. Participation in the wage sector increases modestly from 34 percent to 39 percent

as a result of the subsidy; however, the policy exhibits substantial crowding out. Fixing labor market tightness, and thus shutting down the crowd-in and crowd-out channels, suggests that the policy should increase wage sector participation to 50 percent in the absence of these effects. The large difference between these two results is evidence that the crowd-out effect dominates quantitatively, arising from the fact that households' job search behavior changes strongly in response to the reduction in their probability of finding a job.

Despite substantial crowding out, the policy still increases average welfare by about 0.6 percent of consumption. When labor market tightness is fixed, welfare increases by 1.2 percent of consumption, suggesting that the net impact of the crowd-out and crowd-in effects is to reduce the welfare gains of the policy by about half. Rather than a large expansion of the wage sector, the welfare gains arise largely from the fact that the subsidy improves insurance by taking resources from the state of the world in which workers are employed and transferring them to the state in which workers are unemployed, which is highly valued by workers. The gains accrue entirely to the unemployed while the employed, who pay the tax required to fund the subsidy, suffer welfare losses of about 1 percent of consumption. Surprisingly, the gains and losses exhibit no substantial pattern with respect to household wealth; poor and rich households both gain (or lose) equally from the policy. Separating the welfare gains into the direct effects of the subsidy and the indirect effects due to higher taxes, crowd-in, and crowd-out does, however, reveal patterns in wealth. In particular, wealthier households benefit more from the direct effects of the subsidy as they are the most likely to be able to fund long periods of job search and collect the subsidy. But wealthier households also experience the largest welfare losses due to the dominance of the crowd-out effects and higher taxes, as they are the most likely to be engaged in wage work where they suffer from both effects. The net result is that changes in welfare are roughly equal for households of all levels of wealth.

1.1. Related Literature

Methodologically, this paper is closely related to the macroeconomic development literature studying the interactions of workers and entrepreneurs in developing countries. The model builds on [Itskhoki & Moll \(2019\)](#) who study optimal Ramsey policies in a model with credit-constrained entrepreneurs and households and find that optimal policy begins by subsidizing entrepreneurship at the ex-

pense of workers to encourage growth. [Buera, Kaboski & Shin \(2011\)](#) show that the allocation of capital across entrepreneurs is a key determinant of productivity, a channel also present in this paper and responsible for driving the crowd-in effect through higher wages. [Buera, Kaboski & Shin \(2021\)](#) study the macroeconomic effects of microloans in a model of heterogeneous agents and endogenous selection into entrepreneurship.

This paper also builds on work that distinguishes between subsistence self-employment and entrepreneurship in the developing world. [Feng & Ren \(2021\)](#) document stark differences between the self-employed with and without employees (referred to as own-account workers and employers respectively) and show that employers' labor share is increasing in GDP while own-account work declines as GDP rises, consistent with the ALMP's goal of moving own-account workers into the wage sector. The model is closely related to the model of [Herreño & Ocampo \(2021\)](#) who study the macroeconomics effects of microloans and cash transfers in a heterogeneous agent model in which poor agents use less productive self-employment to cope with the risks of wage employment (as in this paper). [Donovan, Lu & Schoellman \(2020\)](#) construct detailed measures of worker flows between employment, unemployment, and self-employment for countries of various incomes and show that, in developing countries, self-employment and unemployment exhibit similar flows to employment and that self-employment does not help workers climb the job ladder. These results are consistent with the idea that self-employment in developing countries largely exists as a subsistence activity.

This paper contributes to a recent literature documenting and examining the macroeconomic effects of labor search frictions across the cross-country income distribution. [Feng, Lagakos & Rauch \(2018\)](#) document that overall unemployment rates are increasing in GDP per capita and show that skill-biased productivity differences can explain a large fraction of the observed variation in a model with frictional labor markets and frictionless self-employment. I expand on their model by adding risk-averse households and financially-constrained entrepreneurs. [Poschke \(2019\)](#) shows that urban unemployment is substantially higher in developing countries and builds a model in which cross-country variation in search frictions can jointly explain cross-country variation in self-employment and urban unemployment rates, consistent with this paper's finding that individuals self-employment decisions respond strongly to changes in job-finding probabilities. In a similar vein, [Banerjee, Basu & Keller \(2021\)](#) find that skilled workers in developing coun-

tries exhibit higher unemployment rates, relative to unskilled workers, than in developed countries and show that this difference leads to differences in occupational choice. Finally, [Porzio, Rossi & Santangelo \(2021\)](#) use a model with frictional reallocation of labor from (self-employment dominated) agriculture to (wage work dominated) non-agriculture to quantify the importance of human capital in explaining the process of structural change.

This paper studies the effects of Active Labor Market Policies in general equilibrium and is thus closely related the empirical literature evaluating the effects of these policies. [Abebe et al. \(2021\)](#) and [Franklin \(2018\)](#) both study the effects of cash transfers to job searchers in extremely similar experiments and find that these subsidies increase search behavior and an individual's probability of being employed in a permanent, formal job after 16 weeks. Interesting, while they find substantial effects on job amenities and self-report job satisfaction, they find no significant effect on earnings. The results and data from these experiments play an important role in the quantitative discipline of this paper's model.

[Algan et al. \(2020\)](#) randomize a government program in France aimed at reducing recruitment and vacancy posting costs for firms and find that the program successfully increased vacancy posted and hirings. Similarly, [De Mel, McKenzie & Woodruff \(2019\)](#) find that wage subsidies effectively increase employment among microenterprises in Sri Lanka but that the impacts of the subsidy are fleeting and employment quickly returns to normal when the subsidy is removed. [Alfonsi et al. \(2020\)](#) evaluate the impact of free training programs, provided either directly to workers for free or provided through firms and subsidized by the experiment. Although this is less directly related to my results as there is no concept of training in the model, it is still an important experimental evaluation of ALMPs and sheds light on a main constraint preventing workers from finding wage sector employment, namely that they lack a credible mechanism through which to signal their abilities.

2. Model

The model features many properties that are characteristic of labor markets in the developing world while remaining computationally tractable. Time is discrete. Because my primary source of data is collected at a weekly frequency, I conceptualize one model period as one week. There is measure one of households and an endogenous measure of entrepreneurs. Households consume, save, and choose

between working in self-employment or participating in the labor market while entrepreneurs operate firms, consume profits, and accumulate capital and labor for future periods.

2.1. Search and Matching

The labor market for wage work exhibits typical search-and-matching frictions. Households must search for jobs and entrepreneurs must hire by posting vacancies. The cost of searching for a job and the cost of posting a vacancy are denoted by b and c respectively. Each period, the number of worker-firm matches is given by a homogeneous of degree 1 matching function $m(u, v)$ where u is the measure of households searching for a job and v is the measure of vacancies posted by firms. As is typical, $\theta = \frac{v}{u}$ is defined to be labor market tightness so that $p(\theta) \equiv m(\frac{1}{\theta}, 1) = \frac{m(u, v)}{v}$ is the probability that any vacancy is filled and $\theta p(\theta) = \frac{m(u, v)}{u}$ is the probability that any searcher finds a job. Finally, matches between workers and firms are separated with exogenous probability λ at the end of every period.

2.2. Households

There exists a unit measure of infinitely-lived households indexed by their wealth a , their employment status e , and their self-employment productivity z . Lifetime household utility is given by

$$E_0 \sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\sigma}}{1-\sigma} \quad (1)$$

Households are endowed with one unit of time each period which they supply inelastically and indivisibly to either work or search each period.¹

Any household can engage in self-employment and operate the self-employment technology $Y = A_s L$. A household's self-employment productivity y_t follows an exogenous Markov process described by transition matrix M . Additionally, I normalize A_s to unity so that self-employment earnings are simply given by y . By assumption, self-employment uses only household labor and does not involve hiring workers from outside the household (which is instead done by entrepreneurs). Thus, this option most closely corresponds to the concept of "subsistence self-employment" (as in e.g. [Herreño & Ocampo 2021](#)).

Instead of engaging in self-employment, a household can choose to pay a search

¹This assumption can be justified by the fact that a model period is one week. Additionally, I've experimented with allowing interior choices of time allocation, and it makes very little quantitative difference as most households choose to fully allocate time to either work or search anyways.

cost b and search for a wage job. A searching household earns nothing in the current period and finds a permanent job with probability $\theta p(\theta)$. After finding a job and becoming employed, a household can either work in their wage job or return to self-employment (of course, in equilibrium, all employed households will choose to engage in wage work). Wages are determined through bargaining (discussed later) and depend on the productivity of the entrepreneur with whom the household is matched, given by z_t .²

Search is undirected, and every vacancy has an equal probability of being filled. Consequently, a household's probability of matching with a job that will pay $w(z)$ conditional on matching with any job, denoted $H(z; X)$, is given by the share of vacancies posted by z -type entrepreneurs. As this depends on entrepreneur behavior, it is function of the vector of aggregate state variables X .

Households face incomplete markets a la [Aiyagari \(1994\)](#), [Bewley \(1977\)](#), and [Huggett \(1993\)](#) and accumulate assets for self-insurance. Each period, assets pay an exogenous rate of return r (i.e. this is a small open economy). Households cannot borrow (i.e. $a_t \geq 0$). The budget constraint for the household can be written

$$a_{t+1} + c_t = (1 + r)a_t + (1 - e_t)((1 - s_t)y_t - s_t b) + e_t w_t(z_t) \quad (2)$$

where $s_t \in \{0, 1\}$ is a choice variable for the household with $s_t = 1$ representing the search decision in period t and $e_t \in \{0, 1\}$ is an indicator variable with $e_t = 1$ indicating that the household is employed in period t .

As discussed above, employed households are separated from their jobs with probability λ . Additionally, the household can lose its job if the entrepreneur employing the household dies which occurs with probability $1 - \Delta$ (as discussed below) or chooses to downsize its labor force. Under generous parameter conditions (satisfied in the estimated model), it can be shown that downsizing never occurs in equilibrium, which I assume throughout the rest of the paper. Thus the probability that an employed household retains its job at the end of the period is given by $(1 - \tilde{\lambda}) = \Delta(1 - \lambda)$.

²Section ?? shows that the bargained wage depends only on the productivity of the entrepreneur, rather than on other entrepreneur or household state variables, justifying the suppression of other state variables in the wage expression.

Taking all of the above, the household's problem can be written recursively as

$$\begin{aligned}
V_u(a, y, s; X) &= \max_{c, a', s' \in \{0,1\}} \frac{c^{1-\sigma}}{1-\sigma} + \beta \left((1 - s\theta p(\theta)) E_{y'}[V_u(a', y', s'; X')|y] + \right. \\
&\quad \left. s\theta p(\theta) (E_{z, y'}[V_e(a', y', z; X')|y, X]) \right) \\
V_e(a, y, z; X) &= \max_{c, a'} \frac{c^{1-\sigma}}{1-\sigma} + \beta \left((1 - \tilde{\lambda}) E_{y'}[V_e(a', y', z; X')|y] + \right. \\
&\quad \left. \tilde{\lambda} E_{y'}[V_u(a', y'; X')|y] \right) \tag{3}
\end{aligned}$$

$$\begin{aligned}
s.t. \quad a' + c &= (1 + r)a + (1 - s)y - sb && \text{for } V_u \\
a' + c &= (1 + r)a + w(z) && \text{for } V_e \\
X' &= G(X) \\
y' &\sim M(y) \\
z &\sim H(z; X)
\end{aligned}$$

where X is a vector of aggregate state variables and G is the household's perception function for the evolution of the aggregate state. V_u and V_e denote the value function of the household while unemployed and employed respectively. Here there is a small timing convention; household's must commit to search decisions one period ahead of time. The purpose of this convention is to prevent households from conditioning their search decision on contemporaneous productivity shocks. This convention simplifies some expressions in Section 5 and has little effect on quantitative results.

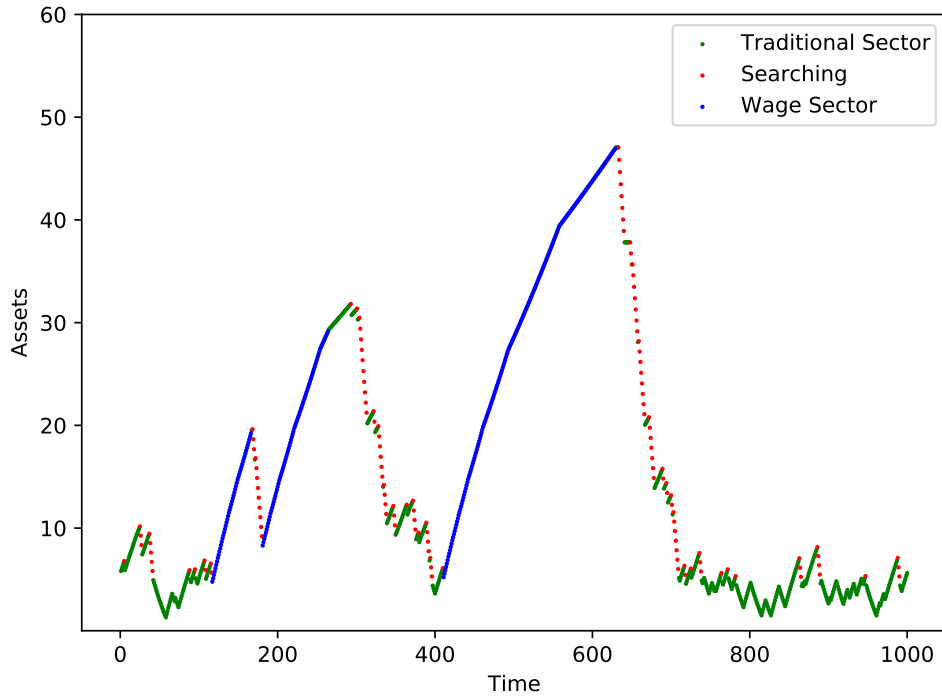
2.3. Household Behavior

Households decide whether to engage in self-employment or search for a wage job by weighing the benefits of search against the costs. In addition to the explicit search cost b and the opportunity cost of forgone self-employment earnings, the presence of borrowing constraints means that the higher risk of job search also serves as a cost, particularly if the probability of finding a wage job is small as is the case in many developing countries.

Only households who are sufficiently self-insured will opt to pay the search

cost and search for wage work, hoping for the slim probability of finding a job and achieving a large boost in earnings, while households without much self-insurance will enjoy the safety of lower but guaranteed income in self-employment. The search cost quickly diminishes the savings of searching households and reduces their self-insurance, eventually driving them to self-employment until they can restore their savings. The result is that households near the threshold of self-insurance spend a few periods working in self-employment and accumulating assets, then switch to searching for a wage job for a few periods, and return to self-employment once their savings have been depleted.

Figure 1: Household Self-Employment and Wage Sector Behavior over Time



This figure plots a simulated household's search, wage work, and self-employment behavior as well as assets over 1000 periods of the household's life. This simulation is performed using the full quantitative calibration of the model described in Section 3.

Figure 1 displays an example of this behavior for a single household simulated for 1000 weeks in the model (i.e. about 20 years). The x-axis displays time while the y-axis displays the household's stock of assets. The color corresponds to the household's search decision in that period; weeks in green are those where the household is engaging in self-employment, red weeks correspond to searching for

wage work, and blue weeks are periods when the household is employed and working for a wage.

The figure demonstrates the household behavior described above. At the start, the household is near the threshold of self-insurance and alternates between working in self-employment and searching for wage work depending on their particular level of assets and self-employment productivity. At around week 150, the household's search is successful, and they acquire a high-earning wage job and quickly accumulate assets. They eventually separate from their employer but use their stock of assets to fund extensive search and remain in the wage sector. This behavior continues for quite some time until approximately week 700 when the household exhausts its assets without finding a job and returns to self-employment punctuated by brief periods of search.

From the perspective of a household, crowd-in and crowd-out effects must occur through changes in either the job finding probability (i.e. labor market tightness) or the expected wage. Anything that increases labor market tightness and lower the job finding probability or lowers the expected wage will cause marginal households to shift from search to self-employment, and decreased labor market tightness or higher wages will increase search. Quantitatively, at least, the crowd-in and crowd-out effects of any policy can be summarized by how it changes these two equilibrium objects. Conceptually, however, there are multiple crowd-in and crowd-out effects pushing market tightness and wages in different directions which Section 5 will explore.

2.4. Entrepreneurs

While households work in either self employment or the wage sector, entrepreneurs operate firms and employ households. The choice to include entrepreneurs as distinct agents separate from household's self employment decisions (in contrast to e.g. Buera, Kaboski & Shin 2021) reflects the qualitative difference between household self-employment-as-last-resort in and out of which households can freely flow (?) and productive entrepreneurship with the potential to grow and potential employ many households.

There are N entrepreneurs each of size $\frac{1}{N}$ born every period, and the model considers the limit $N \rightarrow \infty$.³ At the end of a period, entrepreneurs die with probability

³The assumption that there are an infinite number of atomic entrepreneurs rather than a unit measure of entrepreneurs is non-standard but eliminates many technical difficulties in the discussion of wage bargaining. Other than this, there are no substantive differences between the two

Δ . Entrepreneurs are born with idiosyncratic ability z drawn from some distribution with bounded support $h(z)$ and an initial level of financial wealth \underline{f} (taken to be exogenous). They discount the future at rate β (the same rate as households), face an exogenous death probability Δ each period, and receive lifetime utility from consumption (labeled d_t for “dividends”) given by

$$\sum_{t=0}^{\infty} (\beta\Delta)^t \frac{c_t^{1-\sigma}}{1-\sigma} \quad (4)$$

Each entrepreneur operates a production technology that takes capital k and labor n and produces output y according to an ability-dependent Cobb-Douglas production function:

$$y_t = z k_t^\alpha n_t^{1-\alpha} \quad (5)$$

Entrepreneurs rent capital from the international capital market at an exogenous rental cost $(r + \delta)$ (i.e. this is a small open economy) and pay workers wage w_t , determined by bargaining.

Entrepreneurs are constrained in their choice of both k_t and n_t . In particular, they must use their own assets f_t as collateral and face a collateral constraint

$$k_t \leq \gamma f_t \quad (6)$$

where $\gamma \geq 1$ is a parameter summarizing the degree of financial market frictions, with $\gamma = 1$ representing the case of full self-financing and $\gamma \rightarrow \infty$ representing no financial frictions. While this constraint is exogenous, it can be thought of as arising from unenforceability of contracts or other institutional features that make uncollateralized lending risky.

To hire labor and adjust n_t , entrepreneurs post vacancies v_t . Each vacancy costs c units of output to post and is filled at the end of the period with probability $p(\theta)$. The evolution of n_t is dictated by the equation

$$n_{t+1} = (1 - \lambda)n_t + p(\theta)v_t \quad (7)$$

where λ is the exogenous separation rate.

assumptions.

An entrepreneur's period profits are given by

$$\pi_t(z, k_t, n_t) = zk_t^\alpha n_t^{1-\alpha} - (r + \delta)k_t - w_t n_t \quad (8)$$

Due to the constraints on the choices of k_t and n_t , an entrepreneur will earn positive profits each period. They split these profits between consumption, posting vacancies, and accumulating additional collateral f_{t+1} and face a budget constraint given by

$$d_t + f_{t+1} = \pi_t(z, k_t, n_t) + f_t - cv_t \quad (9)$$

2.5. Wage Bargaining

Each period, entrepreneurs and their hired workers bargain over wages. Because capital acts as a fixed factor of production (as the collateral constraint always binds in equilibrium), output exhibit decreasing returns to scale in labor. To accommodate this, I follow [Smith \(1999\)](#) and, more recently, [Acemoglu & Hawkins \(2014\)](#) and model production as a cooperative game between workers and entrepreneurs in which each agent is paid their Shapley value.

The entrepreneur enters the game with capital k and workforce n . Any worker that chooses not to cooperate will engage in self-employment for a period and then return to the bargaining table in the next period. That is, the outside option for the worker takes the form of a temporary strike in which the match between worker and firm is preserved (rather than being terminated). To maintain tractability, the productivity of a striking worker is assumed to be non-stochastic and identical across all workers, equal to the average productivity in the economy \bar{y} . This simplifies the problem dramatically as it allows the productivity of every uncooperative worker to be known a priori, rather than depending aggregate state variables such as the cross-sectional distribution of workers over productivity states and employment.

If the entrepreneur and x of the n workers choose to cooperate, they form a coalition, operate the entrepreneur's production technology, and produce $zk^\alpha x^{1-\alpha}$. The remaining $(n - x)$ workers form their own coalition and produce $(n - x)\bar{y}$. Each agent is paid their Shapley value arising from this game, so that the wage per worker is given by

$$w = \chi zk^\alpha n^{-\alpha} + (1 - \chi)\bar{y} \quad (10)$$

where χ is a parameter governing the bargaining power of the entrepreneur rela-

tive to workers.⁴ This wage determination equation is intuitive; workers are simply paid some linear combination of their marginal product of labor and their outside option \bar{y} , with the weight determined by bargaining power.

2.6. The Entrepreneur's Problem and Behavior

Combining equations 4 - 9 and the wage bargaining equation 10, the entrepreneur's problem can be written recursively as

$$\begin{aligned} V(z, f, n; X) &= \max_{f', n', k, v, d} \frac{c^{1-\sigma}}{1-\sigma} + \beta \Delta V(z, f', n'; X) \\ \text{s.t. } d + f' &= (1 - \chi) z k^\alpha n^{1-\alpha} - (r + \delta) k - (1 - \chi) \bar{y} n + f - cv \\ n' &= (1 - \lambda) n + p(\theta) v \\ k &\leq \gamma f \\ v &\geq 0 \\ X' &= J(X) \end{aligned}$$

where X is a vector of aggregate state variables and J is the entrepreneur's perceptions function for the evolution of the aggregate state. It is important to note that the wage bargaining equation has been substituted into the entrepreneur's budget constraint and does not depend on household state variables, eliminating the need to anything about the composition of households employed by the entrepreneur as state variables.

This problem is complex, but substantial insight into entrepreneur behavior can be gained analytically. One important result arising from the first order conditions for f' and n' is that an entrepreneur's capital-labor ratio depends only on their productivity z and aggregate state variables X , conditional on choosing positive employment (see Appendix B for the derivation).⁵ Denote this value as η so that

$$\eta(z; X) = \frac{\gamma f'^*}{n'^*} \quad (11)$$

where f'^* and n'^* are the entrepreneur's optimal policy functions. The intuition for this result is straightforward; production is Cobb-Douglas and, even accounting

⁴At a technical level, the game is between an atomistic entrepreneur and a continuum of workers; the parameter χ is the relative size of the entrepreneur.

⁵This statement holds in universally in steady-state and holds for any transition path under the parameter restriction that $\lambda > 1 - \beta \Delta$ which is satisfied in the quantitative model.

for wage bargaining, hiring frictions, and collateral constraints, the users costs of both capital and labor are linear, resulting in a constant ratio.

This result substantially increases the computational tractability of the model. In principle the bargained wage may depend on all entrepreneur state variables as well as the state variables of the households they employ, requiring the composition of households employed by the entrepreneur to be tracked as state variables in the problems of the entrepreneur and employed households as well as solving for a high dimensional equilibrium wage function each period. Because the bargained wage depends only on parameters and the entrepreneur's capital-labor ratio (equation 10), this result collapses all of this heterogeneity into the single state variable z . Further, the equilibrium wage function can be found by solving a simple monotonic non-linear equation of one variable and does not require an iterative procedure.⁶

A second useful result is that entrepreneurs will pursue a constant productivity-dependent growth rate. Mathematically, f'^* will satisfy

$$\begin{aligned} f'^* &= g(z; X)f \\ \frac{\partial g}{\partial z} &> 0 \end{aligned} \tag{12}$$

for some function g . As with the capital-labor ratio, because z is fixed for an entrepreneur, this means that they will grow at a constant rate over their lifetime (in steady-state). Intuitively, g is increasing in z ; more productive entrepreneurs will grow quicker. Together, the two functions η and g are sufficient to fully characterize entrepreneur behavior as a function of their productivity z and the aggregate state X .

2.7. Crowd-in and Crowd-out Effects on Wages

The two functions η and g can be used to gain intuition for the crowd-in and crowd-out effects of a subsidy to labor search that arise from changes in average wages. Because these operate through labor market tightness, it is useful to abuse notation and write $\hat{\eta}(z; \theta)$ and $\hat{g}(z; \theta)$ to represent "the steady-state values of η and g for a z productivity entrepreneur facing steady-state labor market tightness θ ". This abuse is possible because entrepreneur policy functions depend on the aggregate state X only through its implication for current and future values of

⁶This is shown in Appendix B along with the other results discussed in this section.

θ . Intuitively, these functions can be thought of as “partial equilibrium” policy functions that take a value for the price (θ) and return the entrepreneur’s optimal response, enabling comparative-static-like-statements like the following:

Proposition 1 *Let \hat{g} and $\hat{\eta}$ be defined as above. Then*

$$\begin{aligned} \frac{d\hat{\eta}}{d\theta} &> 0 \\ \frac{d\hat{g}}{d\theta} &< 0 \text{ and } \frac{\partial^2 \hat{g}}{\partial z \partial \theta} < 0 \end{aligned}$$

where partial derivatives denoted by ∂ are taken while holding other endogenous outcomes (i.e. $\hat{\eta}$) constant.

In words, Proposition 1 makes three claims. The first ($\frac{d\hat{\eta}}{d\theta} > 0$) is that an entrepreneur’s capital-labor ratio is increasing in labor market tightness. This result is intuitive; a tighter labor market leads to higher hiring costs and thus increases the cost of labor relative to capital. Conversely, a search subsidy that induces households to shift from self employment towards search will loosen the labor market will put downwards pressure on the capital-labor ratio, leading to a reduction in wages. This will lead to crowd out (relative to a world where prices remained fixed) as lower wages will cause marginal searchers to move into self employment.

The second claim that an entrepreneur’s growth rate is decreasing in market tightness ($\frac{d\hat{g}}{d\theta} < 0$) is similarly intuitive; as labor market tightness increases and hiring costs rise, the entrepreneur must spend more on hiring, reducing the profit per unit of collateral, and reducing the incentive to grow (rather than consume).

More interesting is the final statement ($\frac{\partial^2 \hat{g}}{\partial z \partial \theta} < 0$). This is best interpreted as a statement about how the magnitude of the relationship between \hat{g} and θ varies with productivity. It says that the response of \hat{g} to θ is larger (i.e. more negative) for highly productive entrepreneurs. As a result, a search subsidy increases search and decreases labor market tightness, entrepreneur growth rates increase (the second claim), and this increase is larger for high productivity entrepreneurs than low productivity ones. The result is that the share of resources controlled by high productivity entrepreneurs increases, resulting in higher TFP and — because productive entrepreneurs pay higher wages — higher average wages, crowding in additional workers from self employment.

The intuition for this final result is not immediately clear. It arises from the fact that hiring costs make up a larger share of total costs for faster growing firms, which happen to be the more productive firms. To see this, consider a comparison between two entrepreneurs each with a unit measure of employees, identical capital-labor ratios η^* , but one of whom is not growing ($g = 1$) and one of whom is growing at rate g^* .⁷ Total costs for the entrepreneur without growth are given by $r\eta^* + \chi z\eta^* + (1 - \chi)\bar{y} + \lambda \frac{c}{p(\theta)}$ where the final term represents the hiring costs. Total costs from the growing entrepreneur are identical except they carry an additional hiring cost term given by $(g^* - 1) \frac{c}{p(\theta)}$. From this perspective, it is clear that a reduction in $\frac{c}{p(\theta)}$ represents a larger proportional reduction in total costs for the growing entrepreneur, freeing up relatively more resources to use for faster growth.

2.8. Crowd-in and Crowd-out Effects on Job Finding and Hiring

Before turning to quantitative analysis, it is useful to discuss the two remaining crowd-in and crowd-out effects. These are formalized in the optimal policy analysis of Section 5, but an intuitive understanding is helpful for discussion of the quantitative results. Unlike the effects discussed previously which impacted wages, these two effects impact job finding and hiring probabilities.

The first is very straightforward and is closely related to the congestion externality in textbook labor search models. Additional workers who are induced into search by a search subsidy decrease labor market tightness and, through the matching function, decrease the probability that any individual searcher is matched with a job. While this increases the unemployment rate, it does not directly change the size of relative size of the wage sector. However, as with lower wages, marginal searchers respond to lower job finding rates by moving into self employment.⁸

The final crowd-in effect is more subtle and, unlike the previous effects, does not occur as a result of changes in labor market tightness. It arises from another model feature that is common to labor search models — namely, that bargained wages do not fully reflect a worker’s marginal product. Instead, workers are paid slightly less than their marginal product with entrepreneurs collecting the difference as

⁷This example abstracts from the fact that entrepreneurs with different productivities would choose different capital-labor ratios, but it suffices to provide intuition.

⁸As this mechanism serves as the primary means by which the labor market achieves equilibrium, one could argue that calling this a “crowd-out effect” is awkward. However, as Section 5 shows, this effect is not internalized by searchers and appears as a distinct term in the expression for the planner’s optimal search subsidy, justifying its inclusion in the set of crowd-in and -out effects.

additional profits. A portion of these additional profits are used to grow the firm which necessitates hiring additional workers. In this sense, an additional searcher induced by a search subsidy, if they are hired, directly crowds in additional hiring in the future. One way to see this effect clearly is to consider two entrepreneurs each with a unit measure of workers growing at rate g^* , one of whom is exogenously matched with an additional unit measure of workers from outside the economy (e.g. immigrants). The entrepreneur who is not matched with additional workers hires $g^* - 1$ workers on net for the next while while the matched entrepreneur hires $2(g^* - 1)$ workers on net. The unit measure of immigrants effectively crowds-in an additional $g^* - 1$ workers the next period.

All four crowd-in and crowd-out effects push in different directions on wages and wage labor market participation, but no effect is strong enough to dominate in general. As a result, the aggregate impact of a subsidy to search is unclear and, further, it is unclear how and if the experimentally evaluated impact of a subsidy compares. The size of these impacts and which effects dominate is ultimately a quantitative question which motivates the careful model estimate in the next section.

3. Model Estimation and Quantification

In this section, I discuss the estimation and quantification of the model as well as perform some model validation exercises. Broadly speaking, the parameters of the model fall into two categories. The first are parameters that can be estimated directly from data or are well-known macroeconomic parameters with standard values. These parameters I simply set equal to their estimated or standard value. The second set of parameters I estimate using the simulated method of moments to match key moments measured using weekly data on job searchers. In the subsection below, I describe these data as well as the experimental context in which they were collected.

3.1. Experimental Evaluation of Search Subsidies

I use data from an experiment evaluating the effect of providing search subsidies to potential wage workers in Addis Ababa, Ethiopia. The experiment was performed by [Abebe et al. \(2021\)](#) and began in 2014. In the context of Addis Ababa, the majority of openings for permanent wage jobs are posted on job boards located in the city center. To apply for a job, an individual must first travel to the city center, typically by bus, to view the job posting. In this context, the cost of buying a

bus ticket serves as a cost to job search that is both large and salient.

The experiment sampled young individuals who were likely to desire a permanent wage job. In particular, individuals included in the sample “(i) were between 18 and 29 years of age; (ii) had completed high school; (iii) were available to start working in the next three months; and (iv) were not currently working in a permanent job or enrolled in full time education.” (Abebe et al. 2021). Individuals in the sample were randomly offered cash that could be collected in person at the job boards in the city center up to three times per week. To minimize the incentive to travel to the job boards and collect the subsidy with no intention to actually search for work, the subsidy was designed to offset the cost of a bus ticket from each individual’s home to the city center. As a result, each individual was offered a different subsidy amount. I abstract from this heterogeneity when estimating the model and simply use the average amount of the subsidy collected per person per week. Treated individuals were offered the subsidy for 16 weeks. Weekly data on the search behavior and labor market outcomes of both the treated and control groups were collected through phone surveys.⁹

After 16 weeks, the authors calculate the effect of being offered the search subsidy on a variety of labor market outcomes. Their results are replicated in Table A.1. The search subsidy has a significant effect on the type of jobs that searchers have at the end of the 16 weeks. Individuals offered the subsidy are 3.4 percentage points and 5.4 percentage points more like to be in permanent and formal jobs respectively. For the purpose of my model, I interpret this as evidence of an increase in wage employment and choose to treat temporary, informal employment as part of the model’s self-employment sector. There is also some suggestive evidence that the subsidy increases wages and employment, but these estimates are very imprecisely estimated.

These data are useful in quantifying the model for two primary reasons. First, the data collected on the control group provides a high-frequency look at the search behavior of workers. This allows direct observation of many important model moments, such as the probability of finding a job conditional on searching ($\theta p(\theta)$ in the model) or the average level of savings among searchers. Direct observation of these micro moments allows for more direct estimation of model parameters

⁹At the current moment, these data are not publicly available. Instead, I use data collected from an almost identical pilot experiment. These data are published in Franklin (2018). In the future, I plan to use data from the full experiment.

instead of relying on aggregate moments. Second, the experimentally evaluated impact of job search subsidies on wage sector employment provides a valuable moment that directly speaks to the effectiveness of subsidies in encouraging workers to search. Because I have enough parameters to estimate the model, I reserve this moment for model validation, allowing me to check whether the model’s predicted increase in wage employment aligns with reality.

3.2. Directly Estimated Parameters

Many model parameters are chosen to match values typical in the macroeconomics, are taken from external sources, or are estimated directly. These are displayed in Table 1, along with their values and sources. The discount rate β is chosen to match an annual discount rate of 0.95. Because a model period corresponds to two weeks, this corresponds to a value of $0.95^{\frac{1}{26}}$. The rate of return on worker’s savings R is taken to be exogenously equal to $0.9^{\frac{1}{26}}$. The assumption that the return to savings is less than one is typical models of developing countries (see e.g. [Donovan 2021](#), [Fujimoto](#), [Lagakos & VanVuren 2023](#)) and representative of the fact that households in these countries lack access to formal investment with positive returns. The value of 0.9 matches an annual inflation rate of roughly 10 percent, consistent with World Bank estimates of inflation in Ethiopia over the last few years; thus the model asset a most closely reflects cash holdings. The capital share of income is set at 0.33 as is standard.

The interest rate faced by entrepreneurs is disciplined using World Bank MIX Market data containing financial information on microcredit providers in Ethiopia. Yields on loans from microfinance institutions range from 20 percent to 30 percent with negligible loan loss rates (typically less than one percent). Combining this rough average of a 25 percent annual return with 8 percent depreciation yields a depreciation-inclusive user cost of capital of 33 percent annually. This value is high relative to developed countries but is fairly typical for developing countries (see e.g. [Banerjee, Karlan & Zinman 2015](#), who document similar values in multiple countries including Ethiopia).

Collateral constraints are measured directly using data from the Ethiopian portion of the World Bank Enterprise Survey for the year 2015. The average collateral requirement reported by firms is slightly larger than 350 percent of loan value, meaning that a firm that owned 350,000 Birr worth of capital could pledge this as collateral and finance a loan for an additional 100,000 Birr of capital. Thus the

implied value for γ is $1 + \frac{1}{3.5} = 1.29$. The Enterprise Survey is also used to estimate the entrepreneur survival probability Δ . Because productivity is constant for the life of an entrepreneur, entrepreneur death is the only reason that firms will shutdown in steady state. Consequently, the steady-state distribution of firm ages is geometric with decay parameter Δ whose value can be recovered through the simple maximum likelihood estimation. In this case, the estimate for Δ is given by $1 - \frac{1}{\hat{\mu}}$ where $\hat{\mu}$ is the sample average firm age, yielding an annual value for Δ of 0.92.

Table 1: Directly Estimated Parameters

Parameter	Value	Description	Source
β	$.95^{\frac{1}{26}}$	Discount rate	Standard value
R	$.9^{\frac{1}{26}}$	Return to savings	10% annual inflation
α	.33	Capital share	Standard value
r	$1.33^{\frac{1}{26}} - 1$	Capital cost for entrepreneurs	MIX Market
γ	1.29	Collateral constraint	World Bank ES
Δ	$0.92^{\frac{1}{26}}$	Entrepreneur death prob.	World Bank ES

This table displays the model parameters that are estimated directly as well as their values and sources. To help comparisons to typical values, parameters are displayed in annual terms. See the discussion for details on each parameter.

3.3. Parameters Estimated using the Simulate Method of Moments

Table 2: Moments Targeted using the Simulated Method of Moments

Moment	Data	Model	Parameter
Wage Work as % of Total Work	30.0%	34.4%	$\sigma = 5.6$
Median Savings while Self-Employed	$.251y_h$	$.251y_h$	$\frac{y_h}{y_l} = 2.088$
Control Wage Employment after 16 Weeks	17.1%	16.8%	$c = 18.0$
Productivity Transition Prob.	21%	21%	$p = .21$

This table displays the moments targeted in the simulated method of moments estimation and their values in both the data and model. The final column lists the model parameters estimated using SMM and provides a rough, intuitive correspondence indicating which moment is most responsible for disciplining each parameter. See the discussion for details.

Table 2 displays the model moments that are targeted in the simulated method

of moments estimation as well as their values measured in the data and in the model. The final column of Table 2 reports the four estimated parameters corresponding to the four moments. Although all four moments are determined jointly by all four parameters, the correspondence between moments and parameters displayed in the table gives intuition for which moment is most important in estimating which parameter.

The first moment is the percentage of the population engaged in wage work which I calculate to be 30 percent for Addis Ababa based on the data of [Abebe et al. \(2021\)](#). It's worth noting that this is substantially lower than the rates of wage work calculated by the World Bank for Ethiopia which are 10 to 15 percent. Although this is not particularly surprising as it would be expected that urban Addis Ababa would have higher rates of wage employment. In the model, this moment is closely pinned down by the CRRA parameter of the utility function. This correspondence is intuitive as participating in the wage sector carries a higher expected return than participating in self-employment but is subject to idiosyncratic job-finding risk. As a result, conditional on other variables (savings, relative earnings, and job-finding probability), the decision to participate in the wage sector is determined fully by an individual's risk tolerance. I estimate the CRRA parameter to be 5.6, reflecting the fact that workers seem to be very risk-averse in choosing whether or not to engage in wage work.

For those engaged in self-employment, the relative productivity of the high productivity state versus the low productivity state is pinned down by observing savings held by the self-employed or casually employed measured in [Abebe et al. \(2021\)](#). If the gap between productivity states is larger, individuals will hold higher savings to be more self-insured. I estimate that the high productivity state is roughly twice as productive as the low productivity state. Having fixed most of the search parameters in the previous sector, the remaining search parameter, the cost of vacancy posting c , is estimated using the rate of wage work in the control group of [Abebe et al. \(2021\)](#) after the 16 week observation period. Because all other search parameters have been fixed, c directly determines the job finding probability $\theta_p(\theta)$ and thus corresponds closely to this moment. The final moment, the probability of transitioning between productivity states when self-employed, is estimated to match the average transition probability between a week spent without work and a week spent casually working for individuals observed in [Abebe et al. \(2021\)](#)

3.4. Model Validation

As my primary model validation exercise, I replicate the experiment performed by Abebe et al. (2021) in the model and compare the model outcomes to the experimentally estimated outcomes. To emphasize the appropriateness of this exercise to validate the model, it is important to make one note. When using data from the experiment to estimate the model in the section above, I make sure to only use data from the control group of individuals in the experiment. In other words, data from the treatment group is used nowhere in the estimation process. Thus comparing the treatment effect estimated in the experiment, which boils down to a difference in means between the treatment and the control group, provides validation of the model that is independent of the data used to estimate it.

To replicate the experiment in the model, I begin by selecting a representative but small portion of workers. This “representative but small” assumption is important because it captures the idea that an experiment providing a treatment to a few thousand individuals in a city of millions will have essentially zero impact on equilibrium outcomes. When replicating the experiment in the model, I want to capture this notion and ensure that the model predicted experimental effect arises purely due to the treatment and not due to equilibrium adjustment. In a technical sense, I select a representative measure zero set of workers. Because the set is measure zero, outcomes for this group will have no impact on equilibrium objects.

I split the sample into treatment and control groups. The control group receives no changes while the cost of searching for wage work b is changed to be equal to zero for the treatment group. Setting this cost to zero reflects the fact that, in reality, the treatment was designed to exactly offset the cost of a bus ticket to the city center. I then simulate the economy forward for sixteen weeks (sixteen periods), as in the experiment, while tracking the behavior and outcomes of the control and treatment groups. After these sixteen periods are up, the model equivalents of the experimentally estimated treatment effects can be constructed by comparing the mean outcome between the control and treatment groups.

Overall, I find that the model does a very good job of predicting the experimentally estimated outcomes. The model predicts that wage sector employment will be 3.5 percentage points higher (from a baseline of 16.8 percent) in the treatment group after 16 weeks. In reality, the experiment finds that wage sector employment is 3.3 percentage points higher (from a baseline of 17.1 percent) in the treatment group. The fact that the model prediction is remarkably close to the experimen-

tally estimated treatment effect, despite no data from the treatment group being used in estimation, is an encouraging signal of the model's ability to accurately capture the sectoral decision of workers.

4. Quantitative Exercise and Results

As the main quantitative experiment, I implement a cash transfer each period targeted at all individuals who are searching for wage work. I choose the size of the subsidy to be equal size used to validate the model in the previous section. In particular, this subsidy is equal to 13.7 percent of average weekly earnings (across both sectors). Recall that this subsidy size was designed to exactly offset the costs of search. As a result, the subsidy essentially sets the search cost b to zero. For the main exercise, I assume that the subsidy is funded by a flat tax levied on wage workers, rather than a tax on all workers. This is an important distinction as it means that the tax itself serves to distort workers' choice of sector towards self-employment and, as a result, the tax contributes to the crowd-out effect. In the future, I plan to evaluate an alternative scenario where the subsidy is funded by a flat tax on all workers, eliminating this distortion, and compare how the results differ between these two cases.

Table 3 displays the results of this policy. Column (1) displays the value of moments key aggregate moments in the benchmark steady-state of the estimated model while column (2) displays the values of these moments in the post-subsidy steady-state. The policy results in a substantial increase in both GDP and welfare. Welfare increases by 0.6 percent of consumption on average while GDP increases by a little over 2 percent. This increase in GDP is the result of a 5.4 percentage point increase in the size of the wage sector, which is more productive than the self-employment sector, and an increase in wage sector earnings of 1.88 percent. This increase in earnings is the direct result of higher average wage sector TFP in the post-subsidy steady-state of the model. As the subsidy encourages wage work and the labor market slackens, entrepreneurs now dedicate fewer resources towards hiring and more resources to growth. This increase in growth is disproportionately beneficial to higher productivity entrepreneurs, allowing them to increase their market share and increasing TFP. A portion of this higher TFP is shared with workers through higher wages due to bargaining. However, it is important to note that the increase in wages due to higher TFP is not enough to overcome the increase in taxes necessary to fund the policy; post-tax earnings in the wage sector

decrease by 0.5 percent

Table 3: Results of Implementing Search Subsidies

Variable	(1) Benchmark	(2) Subsidy	(3) Partial Eq.
GDP (relative to benchmark)		+2.06%	+4.10%
CE Welfare		+0.60%	+1.25%
Size of Wage Sector	34.4%	39.8%	50.5%
Wage Sector Earnings		+1.88%	+0.00%
Wage Sector Earnings (includ. tax)		−0.50%	+0.00%
Labor Market Tightness	0.094	0.074	0.094
Job-Finding Prob.	3.10%	2.95%	3.10%
Unemployment Rate	18.6%	19.4%	18.6%

This table displays the results of the primary quantitative exercise of subsidizing search for wage jobs. Column (1) reports key aggregate parameters in the steady-state of the model before implementation while Column (2) reports these same parameters in the new steady-state of the model once the policy has been implemented. Column (3) displays the results in a hypothetical steady-state where labor market tightness θ is fixed. See the discussion for details on how to interpret these results.

The search subsidy has only a modest impact on the size of the wage sector which increases from 34.4 percent to 39.8 percent. Labor market tightness decreases resulting in a small decrease in the job-finding probability from 3.1 percent to 2.95 percent and, consequently, an increase in the unemployment rate by 1.2 percentage points. The decrease in job-finding probability together with the decrease in post-tax earnings in the wage sector strongly suggests that the crowd-out effect dominates the crowd-in effect. To investigate this quantitatively, I perform an additional numerical experiment. Because the crowd-out and crowd-in effects operate through labor market tightness and earnings, both of which are equilibrium objects, I also compute the results of the subsidy if these equilibrium objects were fixed to their pre-subsidy values.

The results of this numerical experiment are displayed in column (3) of Table 3. I interpret these results (when compared to the pre-subsidy model) as revealing the direct impact of the subsidy on workers' decisions and outcomes while

the difference between these results with fixed labor market tightness and wages then reveals the impact of the general equilibrium effects of the subsidy. The most striking difference between this numerical experiment and the post-subsidy steady state is the size of the wage sector. When equilibrium parameters are fixed, the subsidy increases wage sector participation by a remarkable 16.1 percent points to 50.5 percent. Nearly three times as much as the 5.4 percentage point increase induced by the policy in full equilibrium. This stark difference suggests that the direct impact of the search subsidy is large; search costs serve as a substantial constraint in preventing workers from participating in the wage sector.

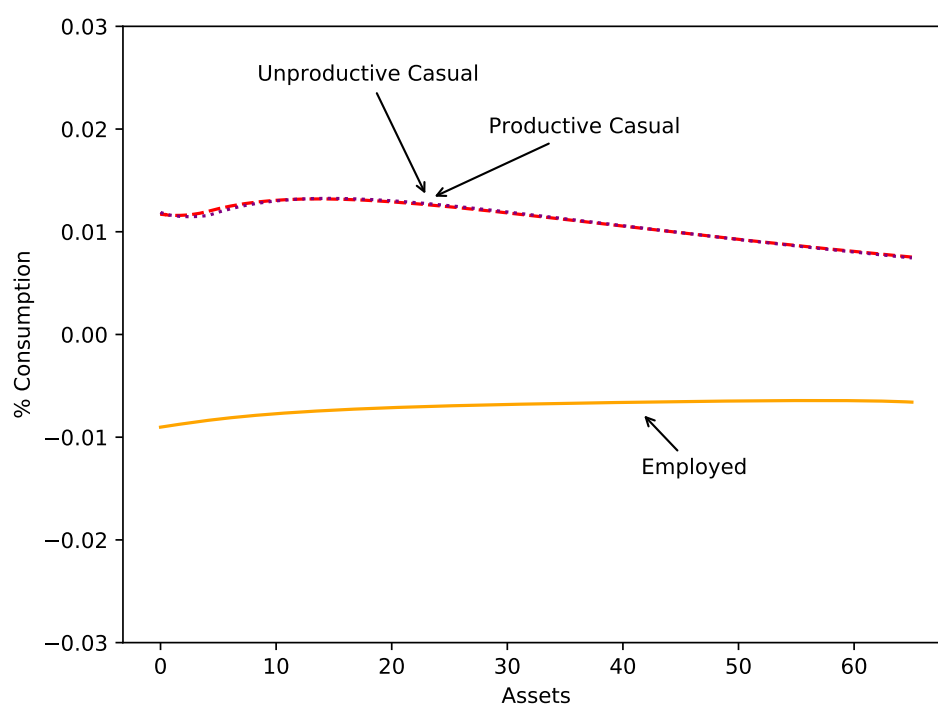
The large difference in wage sector participation between the full equilibrium results and the results with equilibrium values fixed also suggests that the crowd-out effects play a substantially larger quantitative role than the crowd-in effects. As can be seen from column (3), when equilibrium adjustment is shut down, the crowd-in and crowd-out channels are shut down. Labor market tightness is fixed, there is no change in the job-finding probability or in taxes that may crowd out wage workers. Similarly, because wages are fixed, there is no increase in the wage due to higher TFP that could crowd-in additional workers. Once both these channels are introduced, the size of the wage sector falls substantially, consistent with the notion that the crowd-out channels dominate.

Interestingly, the crowd-out effect seems to be large despite a fairly small decrease in the job-finding probability in the new equilibrium. The probability falls by 0.15 percentage points from 3.10 percent to 2.95 percent, a small decline. This large change in the size of the wage sector despite a small decline in job-finding probability indicates that the semi-elasticity between an individual's search choice and their probability of finding a job must be fairly large, likely a direct result of high estimated risk aversion. This behavior seems consistent with experimental interventions such as [Alfonsi et al. \(2020\)](#) and [Abebe, Caria, Fafchamps, Falco, Franklin, Quinn & Shilpi \(2017\)](#) that find large impacts on search behavior of treatments that lead individuals to substantially revise their expectations of their job-finding likelihood.

4.1. Welfare

Figure 2 displays the welfare impact of the search subsidy as a function of individual assets and employment status. For now, these numbers are calculated by comparing steady-states, although I plan to compute welfare along the transition

Figure 2: Welfare Effects of Search Subsidy as a Function of Household Assets



This figure displays the change in welfare, measured in consumption equivalent welfare, of the search subsidy policy as a function of a household's assets as well as their employment status and self-employment productivity.

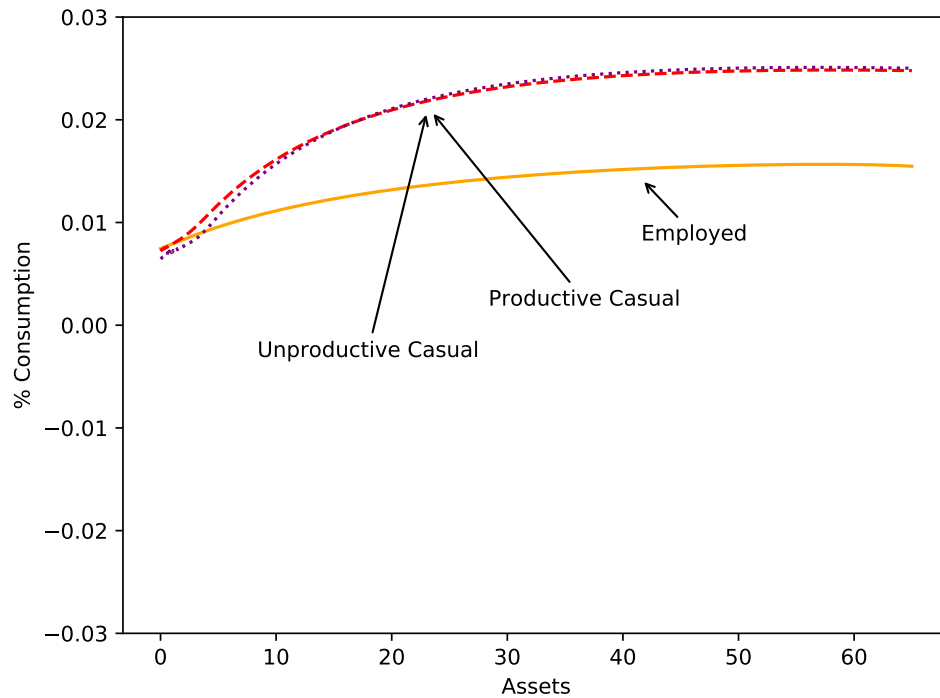
path in the future. The red and purple lines display the welfare impact for workers without a wage sector job in the high productivity and lower productivity states respectively while the orange line displays the impact for workers matched with a wage job. Two aspects of the figure are striking. The first is that the welfare effects are highly dependent on an individual's employment state. The workers without a wage job, who switch between engaging in self-employment and searching for work, experience large welfare gains equal to around 1 percent of consumption while workers matched with an employer experience welfare loss of a little less than 1 percent. This gap is intuitive; workers without a wage job are either searching or anticipate to be searching in a few periods and thus are direct beneficiaries of the subsidy while workers already matched with a job pay a tax in order to fund the subsidy.

The second striking aspect of Figure 2 is that the welfare impacts exhibit very little heterogeneity with respect to an individual's level of wealth; individuals with zero assets experience welfare changes similar to the highest asset individuals. At first glance this result seems puzzling; however, splitting the welfare impact into the direct impact of the subsidy and the indirect impact through equilibrium objects reveals the intuition. Figure 3 displays the effect of the subsidy on welfare as a function of assets while fixing the equilibrium values of labor market tightness, wages and taxes (i.e. corresponding to column (3) of Table 3) while Figure 4 displays the difference between this counterfactual and the full results. In essence, Figure 3 displays the direct impact of the subsidy while Figure 4 displays the indirect impact.

In these figures, the impact of the policy is clearly heterogeneous with respect to individual wealth. The direct effect of the subsidy exhibits the largest welfare gains for the wealthiest individuals. Recall that households will participate in the wage sector until their self-insurance falls below a certain level, after which they will turn to self-employment until they have accumulated a buffer stock of savings. Because wealthy individuals can run down their assets for longer than poor individuals while searching for a job, they expect to collect the subsidy for more periods than poor households, who may only be able to search for a handful of periods before turning to self-employment. The welfare losses from the indirect effects of the policy are largest for wealthy households for a similar reason. Because wealthy households expect to participate in the wage sector the longest, they face the largest losses from a decline in the job-finding probability and an increase in

taxes. Although the indirect effect and the direct effect individually exhibit substantial heterogeneity with respect to wealth, when they are combined the larger gains and larger losses for wealthy households serve to counteract each other and the overall welfare change doesn't vary much with wealth.

Figure 3: Welfare Effects of Search Subsidy as a Function of Household Assets (Fixed θ)



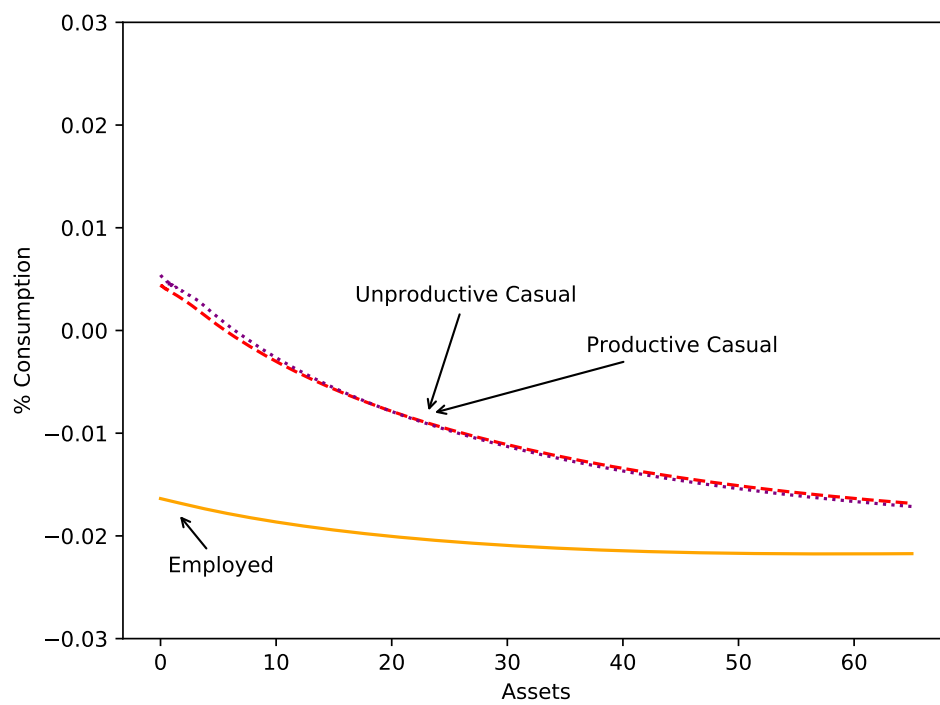
This figure displays the change in welfare, measured in consumption equivalent welfare, of the search subsidy policy as a function of a household's assets as well as their employment status and self-employment productivity in an alternative model where labor market tightness θ is fixed and does not change as a result of the policy. See the discussion for intuition on how to interpret these results.

5. Optimal policy and the theory of the second best

So far, I have focused on a positive description of the general equilibrium effects that are key for understanding the implementation of labor search subsidies. Lorem ipsum...

A substantial complication in analyzing the externalities present in households' labor search decisions is that it is not immediately clear what the appropriate social planner's problem is. As in much of the labor search literature, the

Figure 4: Difference Between Welfare Effects of Subsidy with and without Fixed θ



This figure shows the difference in the change in welfare as a function of household assets, employment status, and self-employed productivity between the full model and the alternative model with fixed θ . See the discussion for intuition on how to interpret this figure.

problem of an all-powerful planner free from any financial constraints or labor market frictions is uninteresting (except perhaps as a benchmark); this planner would simply allocate all labor and capital to the most productive entrepreneur, assuming one exists, and divide output in a way that equalizes marginal utility across all households and entrepreneurs. This teaches us nothing about the externalities generated by households' labor search or how these externalities interact with borrowing constraints.

Instead, I follow the traditional approach and consider the problem of a constrained social planner who is subject to labor market frictions and must respect households' borrowing constraints (as in [Davila, Hong, Krusell & Ríos-Rull 2012](#)). Further, because the goal of this section is to examine the externalities exerted by *households* in their labor search decisions (as this is ultimately the outcome affected by a subsidy to labor search), I assume that the social planner can only dictate the decisions of households. The social planner cannot control the behavior of entrepreneurs (and puts zero weight on their utility), and they continue to solve their optimization problem each period. In this sense, the social planner faces an additional constraint that it cannot force entrepreneurs to act sub-optimally. Allocations satisfying these three constraints make up the set of feasible allocations for the social planner.

Definition: A path of household policy functions $\{c_t(a, y, z), a'_t(a, y, z), s_t(a, z)\}_{t=0}^{\infty}$, entrepreneur policy functions $\{g_t(z), \eta_t(z)\}_{t=0}^{\infty}$, distributions of households across savings and matched-employer productivities $\{m_t(a, z)\}_{t=1}^{\infty}$, and labor market tightness $\{\theta_t\}_{t=0}^{\infty}$ is **feasible** given an initial distribution $m_0(a, z)$ and market tightness θ_{-1} if

1. It respects the household budget constraint for all a, y, z

$$\begin{aligned} a'_t + c_t &= Ra + (1 - s_t)y + s_t(w_t(z_t, \theta_t) - (1 - z_t)b) \quad \forall a, y, z, t \\ a_t &\geq 0 \end{aligned} \tag{13}$$

Note here that the independence of s_t on y enforces the informational constraint that the planner cannot condition search policy on the realization of individual's idiosyncratic shock, mirroring the informational constraint for individuals in competitive equilibrium.

2. It respects the labor market matching technology

$$\begin{aligned} \frac{v(m_t, \eta_t, \eta_{t+1}, g_t)}{\theta_t} &= \int \int s_t(a, 0) m_t(a, 0) j(y) dy da \\ m_{t+1}(a', z) &= (1 - \tilde{\lambda}) m_t(a, z) + H(z, m_t, \eta_t, \eta_{t+1}, g_t) p(\theta_t) v(m_t, \eta_t, \eta_{t+1}, g_t) \end{aligned} \quad (14)$$

where v is the total number of posted vacancies as a function of entrepreneur policy functions, and H is the probability that an individual who finds a job is matched with a firm of productivity level z (defined for compactness and simplicity; both are further described in Appendix C)

3. The entrepreneur policy functions $\{g_t(z), \eta_t(z)\}_{t=0}^{\infty}$ solve the entrepreneurs' problem (Appendix equation 20), conditional on θ_{-1} and $\{\theta_t\}_{t=0}^{\infty}$.

The task of the social planner is maximize average household welfare subject to these feasibility conditions (and initial conditions). Formalizing the statement of this problem is straightforward but cumbersome and is relegated to Appendix C. One detail worth noting is that the constrained planner simply chooses the entire sequence $\{\theta_t\}_{t=0}^{\infty}$ simultaneously, that is, the planner's problem features full commitment.

This problem of selecting the welfare maximizing path subject to a set of dynamic constraints in a heterogeneous agent economy is similar to the Ramsey-type problems often found in the literature dealing with welfare and efficiency in heterogeneous agent models (e.g. [Itskhoki & Moll 2019](#), [Dávila & Schaab 2023](#)). Like all Ramsey problems, the primal problem of choosing paths of consumption (or with heterogeneous agents, consumption functions) subject to feasibility constraints can be equivalently formulated as a dual problem in which the planner selects optimal tax rates from a sufficiently rich set of instruments to decentralize the optimal allocation in competitive equilibrium.

Here, the equivalent dual problem provides some intuition for the relevance of this planner's problem to the notion of an optimal labor search subsidy. The constraint that the planner cannot dictate the behavior of entrepreneurs and is restricted to paths of g_t and η_t consistent with entrepreneur optimality is equivalent to a constraint in the dual problem that the set of available tax instruments does not include any taxes levied on entrepreneurs. Similarly, the constraint that the planner must respect household budget constraints corresponds to a restriction that the set of tax instruments does not include any lump-sum transfers. Thus the only tax

instruments available under the dual approach are taxes on earnings, search, and savings, all of which are potentially individual-specific.

5.1. Search Externalities without Credit Constraints

To generate some initial intuition, I start by examining externalities in the special case where household utility is given by $u(c) = c$ (i.e. $\sigma = 0$). As the exogenous small open economy interest rate is less than the household discount rate by construction, the optimal savings policies in both the competitive equilibrium and the planner problem are to save nothing and consume all disposable income every period. This essentially eliminates ex-post heterogeneity outside that of the labor market, leading to substantial simplifications.

Proposition 2 *Under the assumptions that traditional sector productivity y has no autocorrelation and $\sigma = 0$, the optimal search policies $s(a, z)$ of constrained social planner (described above) and an individual in competitive equilibrium in steady state are to search if and only if*

$$\text{Individual: } \int (y + b)j(y)dy \leq \beta \bar{\theta} p(\bar{\theta}) \int_z \frac{w(z, \bar{\theta}) - \int (y + b)j(y)dy}{1 - \beta(1 - \bar{\lambda})} dz \quad (15)$$

$$\text{Planner: } \int (y + b)j(y)dy \leq \beta \bar{\theta} p(\bar{\theta}) \int_z \frac{w(z, \bar{\theta}) - \int (y + b)j(y)dy}{1 - \beta \Delta g(z, \bar{\theta})} dz + \mu \quad (16)$$

$$\begin{aligned} \mu = & \frac{\bar{\theta}/\bar{S}}{\frac{\partial \log v}{\partial \log g} \frac{\partial \log g}{\partial \log \theta} - 1} \left(\underbrace{\int_z \bar{\lambda}(z) \bar{\theta} p(\bar{\theta}) \bar{S} \frac{\partial H}{\partial g} \frac{\partial g}{\partial \theta} dz}_{\text{Composition of Jobs}} + \right. \\ & + \underbrace{\int_z \bar{\lambda}(z) \bar{H} \bar{S} p(\bar{\theta}) \left(1 + \frac{\partial \log p}{\partial \log \theta}\right) dz}_{\text{Congestion}} + \underbrace{\frac{1}{\beta} \int_z \frac{\partial w}{\partial \eta} \frac{\partial \eta_{t-1}}{\partial \theta} \bar{m}(z) dz + \int_z \frac{\partial w}{\partial \eta} \frac{\partial \eta_t}{\partial \theta} \bar{m}(z) dz}_{\text{Wage Changes}} + \quad (17) \\ & \left. + \text{Anticipation Terms} \right) \end{aligned}$$

where bars denote steady-state values of the competitive equilibrium and planner's problem

respectively, \bar{S} is the steady-state number of searchers defined for compactness, and $\lambda(z)$ is the planner's shadow price denoting the marginal value of an additional worker being matched with a productivity z entrepreneur. The anticipation terms are described further in the appendix.

From the proposition, it is clear that the privately and publicly optimal decision rules follow a similar structure. Each rule weighs the costs of search, given by the goods cost of search b and the expected cost of forgone wages, against the benefits, given by the expected excess earnings while employed. In the privately optimal rule, these excess earnings are discounted by the intertemporal discount rate and probability of maintaining the job match. In the publicly optimal case, they are discounted by the intertemporal discount rate and the shutdown-inclusive growth rate of matched entrepreneur. I deferred further discussion of this difference in discounting to the discussion of crowd-in effects.

The planner's optimal decision rule carries an additional term μ which contains all but one of the externalities present in the labor search decision. The terms contained in μ represent externalities that occur through changes in labor market tightness θ and thus are weighted by the net change in labor market tightness due to a change in the number of searchers after accounting for the response of vacancies.¹⁰ This weight is negative, reflecting the fact that an increase in the number of searchers leads to a decreases in labor market tightness. Thus negative terms within the parentheses represent positive externalities and vice versa.

The negative externalities of search are contained in the second line of equation 17. These are the forces driving the crowd-out effects. The first term, labeled "Congestion", is typical in search models; an additional searcher pushes down labor market tightness and reduces the probability that any given searcher finds a job. As is typical, the size of this externality is proportional to the elasticity of the matching function; a high elasticity implies that an additional searcher leads to a large reduction in the job-finding probability. Intuitively, this externality is also increasing in the steady-state number of searchers \bar{S} and is valued using the average shadow value of a newly hired worked (i.e. $\int_z \lambda(z) \bar{H} dz$).

The second negative externality, given by the "Wage Changes" term, captures the fact that a reduction in labor market tightness leads to reduced labor costs, and entrepreneurs respond by lowering their capital-labor ratio, resulting in lower

¹⁰To see that this expression indeed gives the net change, note that $\theta = \frac{v(\theta)}{s} \Rightarrow \frac{d\theta}{ds} = \frac{\theta/s}{\frac{d \log v}{d \log \theta} - 1}$.

wages (see equation 10, the wage bargaining equation). This effect is similar to the monopoly effect of [Itskhoki & Moll \(2019\)](#) and stems from a similar source, namely, that the planner places zero weight on the welfare of entrepreneurs. While this effect occurs contemporaneously with an increase in search behavior, it is slightly offset by a countervailing anticipation effect. When entrepreneurs foresee a reduction in labor market tightness, they respond by reducing hiring in the period before (as labor will be cheaper tomorrow), temporarily pushing up the capital-labor ratio and, consequently, wages. Because this effect occurs exactly one period before the change in labor market tightness, it is appropriately weighted by $\frac{1}{\beta}$.

The remaining term, "Composition of Jobs" is the first of two externalities corresponding to the crowd-in effects. It arises from the fact that a decrease in labor market tightness will cause entrepreneurs to grow faster (as their labor costs have gone down, leaving more profit available to save and finance capital in the next period). This results in a positive externality because, as shown in [Proposition 1](#), the increase in the growth rate is larger for more productive entrepreneurs. Thus the change in hiring probabilities in response to a reduction in labor market tightness $-\frac{\partial H}{\partial g} \frac{\partial g}{\partial \theta}$ is positive for high values of z and negative for low values, leading to a net increase in allocative efficiency. While the planner internalizes this according to the shadow price $\lambda(z)$, in competitive equilibrium it manifests itself as a higher expected wage and thus induces additional labor search.

The final externality does not operate through labor market tightness. Instead, it emerges from the different discount rates exhibited in the individually and socially optimal search decision rules in [15](#) and [16](#) respectively. Under parameter assumption (made throughout this paper) that $\Delta\beta > (1-\lambda)$, we have that $\Delta g(z, \theta) > (1-\tilde{\lambda})$ for all z, θ . Thus the planner's valuation of a job is higher than an individual's, even fixing labor market tightness.

Why is this the case? The key arises from the fact that the individual does not capture the entire marginal product of labor created by their job match. Instead, they earn some markdown according to [10](#), and the remainder is captured by the entrepreneur. Although the social planner does not value the entrepreneur's consumption, a portion of this remainder is saved and used to expand the entrepreneur's firm in the next period, including new hiring which the social planner values. Essentially, a portion of the worker's production today is used to finance the hiring of additional workers tomorrow, whose production is used to finance more workers the next period, etc. Intuitively, this effect is larger for more pro-

ductive matches (appearing in 16 as a higher growth rate) and smaller when entrepreneur survival probabilities Δ are smaller.

6. Conclusion

Overall, my results suggest that the impact of subsidies for labor search is complex but, generally speaking, substantially smaller in general equilibrium than experimental results would suggest. As an Active Labor Market Policy designed to encourage participation in the market for wage labor and reduce self-employment, the effects are substantially muted, largely due to households' high elasticity of labor search with respect to job-finding probability. Even the substantial subsidy evaluated in this paper only increases wage sector participation by 5.4 percentage points in general equilibrium. The subsidy results in a small increase in TFP in the wage sector as a large wage sector allows more productive entrepreneurs to increase their relative size. Although capital per worker declines in response, this increase in TFP is still enough to boost wage sector earnings by 1.88 percent.

Despite its muted effects in expanding the wage sector, the subsidy does substantially increase welfare by about 0.6 percent of consumption. This gain occurs almost entirely due to the increase in insurance that the subsidy provides. The subsidy transfers resources from a good state of the world (wage employment) to a bad state of the world (search) which is very valuable to households as they lack the means to do so effectively. These gains accrue entirely to unemployed households of all asset levels while employed households suffer welfare losses. The intuition is straightforward as unemployed households are the direct beneficiaries of the policies while employed households pay the taxes required to fund it.

One potentially important channel missing from this analysis is that of entry into entrepreneurship. It seems intuitive that subsidies expanding the market for wage labor would have an impact on business formation and entry into entrepreneurship; however, it is unclear, even in theory, which direction this effect will push. On one hand, it might be the case that the reduction in hiring costs lowers the cost of operating a business and encourages entrepreneurship. On the other hand, while I model entrepreneurs and workers as two completely different types of agents, it's possible that a subsidy for search would induce some entrepreneurs to close their businesses and pursue wage work, reducing the number of entrepreneurs. Additionally, in both these cases, the marginal entrepreneur choosing to close or open a business likely possess lower than average productiv-

ity, leading their entry decision to affect TFP and average earnings as well. Because of a lack of solid empirical evidence to discipline any of these channels and because of their theoretical ambiguity, I choose to abstract from them. However, future work could examine these channels more closely.

Future work could also examine the impact of Active Labor Market Policies aimed at firms such as hiring subsidies or subsidized apprenticeships. My results suggest that search subsidies alone are not sufficient to expand the wage sector, largely because the labor market slackens and the probability of finding a job decreases. These effects could be mitigated by policies aimed at increasing hiring by firms which would tighten the labor market. A combination of subsidies for job seekers and subsidies for firms may be the most effective tool for policymakers looking to expand wage sector employment.

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Appendix

A. Additional Tables and Figure

Table A.1: Effect of Search Subsidy on Labor Market Outcomes ([Abebe et al. 2021](#))

Outcome	Control Mean	Effect of Subsidy
Any Work	0.526	0.037 (0.029)
Hours Worked	26.18	0.183 (1.543)
Monthly Wages	857.9	65.88 (63.86)
Permanent Job	0.171	0.033* (0.018)
Formal Job	0.224	0.054** (0.019)
Job Satisfaction	0.237	-0.001 (0.027)

This table reproduces the primary results of [Abebe et al. \(2021\)](#) and displays the control mean for a variety of labor market outcomes as well as the experimentally estimated treatment effect of a conditional cash transfer to job seekers.

B. Derivations and Proofs from Section 2.6

The first result to show is that the entrepreneur's optimal choice of f' and n' satisfy $\eta(z; X) = \frac{\gamma f'^*}{n'^*}$ for some function η depending only on z and X . Substituting in the wage determination equation (which the entrepreneur takes as given) and the vacancy posting constraint, the first-order condition for f' and n' can be combined with the envelope condition for f and n to generate

$$\begin{aligned} \beta \Delta \mu' \left((1 - \alpha)(1 - \chi)z \left(\frac{\gamma f'}{n'} \right)^\alpha - \left((1 - \chi)\underline{w} - \frac{c}{p(\theta(X'))}(1 - \lambda) \right) \right) &= \frac{c}{p(\theta(X))} \mu \\ \beta \Delta \mu' \left(\gamma \alpha (1 - \chi)z \left(\frac{\gamma f'}{n'} \right)^{\alpha-1} + 1 - \gamma(r + \delta) \right) &= \mu \end{aligned}$$

where μ is the Lagrange multiplier on the budget constraint, μ' is the Lagrange multiplier on the budget constraint in the following period, and $\theta(X')$ is a price

function mapping aggregate states X to equilibrium values of θ . Combining these two equations, substituting in η , and defining A , $B(X')$, and $C(X')$ for clarity yields

$$Az\eta^\alpha + B(X, X')z\eta^{\alpha-1} + C(X, X') = 0$$

which, for $0 < \alpha < 1$, can be shown to have a unique and positive solution for η for any value of z , X , and X' . Call this solution $\tilde{\eta}(z; X, X')$. Finally, substituting $X' = H(X)$ and defining $\eta(z; X) = \tilde{\eta}(z; X, H(X))$ completes the derivation.

The next result to show is that entrepreneurs choose a growth rate that depends only on their z and aggregate state variables. This follows almost directly from the previous result. Substituting $n = \frac{\gamma}{\tilde{\eta}(z; X)}f$ in to the budget constraint of the entrepreneur problem reveals that the RHS of the budget constraint is now linear in f and can be written

$$\begin{aligned} & d + \left(1 + \frac{c}{p(\theta(X))} \frac{\gamma}{\eta(z; X)}\right) f' \\ & = \\ & \left((1 - \chi)\gamma z \tilde{\eta}(z; X)^{\alpha-1} - ((1 - \chi)\underline{w} - \frac{c}{p(\theta(X))}(1 - \lambda)) \frac{\gamma}{\tilde{\eta}(z; X)} + (1 - \gamma(r + \delta)) \right) f \\ & \Rightarrow d + E(z, X)f' = D(z, X)f \end{aligned}$$

where $D(z, X)$ and $E(z, X)$ are defined such that the second line is equivalent to the first line. E functions as the price of collateral f relative to the price of consumption d while D functions as the return to collateral. Because entrepreneurs possess log utility, the entrepreneur problem has the well-known solution of a constant growth rate in f depending on the values of D and E which are given by z and X so that $f' = g(z; X)f$.

The final result to show is the proof of Proposition 1. By assumption, θ is assumed to be constant. Let $\hat{E}(z, \theta)$ and $\hat{D}(z, \theta)$ denote E and D respectively, but with $\theta(X)$ simply replaced by θ , the argument to the function. Note that this is possible because E and D only depend on X through θ . Then we have the explicit

solution¹¹

$$\begin{aligned}\hat{g}(z, \theta) &= \left(\beta \Delta \frac{\hat{D}(z, \theta)}{\hat{E}(z, \theta)} \right)^{\frac{1}{\sigma}} \\ &= \left(\beta \Delta \frac{((1 - \chi)\gamma z \hat{\eta}(z; \theta)^{\alpha-1} - ((1 - \chi)\underline{w} - \frac{c}{p(\theta)}(1 - \lambda)) \frac{\gamma}{\hat{\eta}(z; \theta)} + (1 - \gamma(r + \delta)))}{(1 + \frac{c}{p(\theta)} \frac{\gamma}{\hat{\eta}(z; \theta)})} \right)^{\frac{1}{\sigma}}\end{aligned}$$

The chain rule yields $\frac{d\hat{g}}{d\theta} = \frac{\partial \hat{g}}{\partial c/p(\theta)} \frac{dc/p(\theta)}{d\theta} + \frac{\partial \hat{g}}{\partial \hat{\eta}} \frac{d\hat{\eta}}{dc/p(\theta)} \frac{dc/p(\theta)}{d\theta}$. Using either direct calculation of partial derivatives or implicit differentiation (in the case of $\frac{d\hat{\eta}}{dc/p(\theta)}$), we can express each individual piece as

$$\begin{aligned}\frac{\partial \hat{g}}{\partial c/p(\theta)} &= -\frac{1}{\sigma} \hat{g}^{1-\sigma} \left(\frac{(\frac{\hat{g}}{\beta \Delta} - 1) + \lambda}{\frac{\eta}{\gamma} + \frac{c}{p(\theta)}} \right) \leq 0 \\ \frac{\partial \hat{g}}{\partial \hat{\eta}} &= \frac{1}{\sigma} \hat{g}^{1-\sigma} \left(\frac{\frac{\beta \Delta}{\hat{g}} - \frac{\hat{g}}{\beta \Delta}}{\frac{\eta}{\gamma} + \frac{c}{p(\theta)}} \right) \leq 0 \\ \frac{d\hat{\eta}}{dc/p(\theta)} &= \frac{\gamma(\alpha(1 - \chi)z\hat{\eta}^{\alpha-1} - (r + \delta)) + \lambda}{J(\theta)} > 0\end{aligned}$$

where $J(\theta)$ is a placeholder for a complex but unambiguously positive expression and I have made use of the first-order condition for f' in the second expression. It is worth commenting briefly on why the claimed inequalities hold. Both the first and second expressions follow directly from the fact that an optimally acting entrepreneur will ensure that $g \geq \beta \Delta$. This is clearly true as an entrepreneur can always choose to select $k = 0, n = 0$ and simply eat their cake, yielding $g = \beta \Delta$. An entrepreneur will only choose to operate if they can be weakly better off by doing so. The third and final expression follows from the first-order condition for capital which ensures that the marginal product of capital $\alpha(1 - \chi)z\hat{\eta}^{\alpha-1}$ is greater than the marginal cost of capital $r + \delta$ (the MPK is greater, rather than equal to, the marginal cost due to the presence of the financing constraint). Because $\frac{dc/p(\theta)}{d\theta} > 0$ by construction, combining these inequalities with the chain rule provides the result $\frac{d\hat{g}}{d\theta} < 0$ and along the way we have shown $\frac{d\hat{\eta}}{d\theta} > 0$.

The result for $\frac{\partial \hat{g}}{\partial \theta \partial z}$ is straightforward. We have $\frac{\partial \hat{g}}{\partial z} = \frac{1}{\sigma} \hat{g}^{1-\sigma} \left(\frac{(1-\chi)\hat{\eta}^\alpha}{\frac{\eta}{\gamma} + \frac{c}{p(\theta)}} \right)$ which is also

¹¹Note that this is isomorphic to a textbook cake-eating problem under CRRA utility with the addition that the cake can grow or depreciate at a constant rate. While the policy function discussed here is an intuitive generalization of the well-known textbook solution $f' = \beta^{\frac{1}{\sigma}} f$, I have not located any discussion of this exact problem to cite. Thus, the derivation is available upon request.

clearly greater than zero and decreasing in θ . Although this result holds only for partial derivatives (i.e. with $\hat{\eta}$ being held constant), it can also be shown to hold for total derivatives in the case where $\hat{\eta} \geq \alpha(1 + \frac{c}{p(\theta)}\gamma)$ by applying the chain rule as above and computing $\frac{d\hat{\eta}}{dz}$ using implicit differentiation.

C. Derivations and Proofs from Section 5

First, I formally define the functions v and H introduced in equation 14.

$$v(m_t, \eta_t, \eta_{t+1}, g_t) = \int [g_t(z)\Delta \frac{\eta_t(z)}{\eta_{t+1}(z)} - (1 - \tilde{\lambda})] m_t(z) + \frac{\hat{D}(z, \theta_t, \eta_t(z))\gamma f}{\eta_{t+1}(z)} h(z) dz \quad (18)$$

$$H(z, m_t, \eta_t, \eta_{t+1}, g_t) = \frac{[g_t(z)\Delta \frac{\eta_t(z)}{\eta_{t+1}(z)} - (1 - \tilde{\lambda})] m_t(z) + \frac{\hat{D}(z, \theta_t, \eta_t(z))\gamma f}{\eta_{t+1}(z)} h(z)}{v(m_t, \eta_t, \eta_{t+1}, g_t)} \quad (19)$$

The numerator is the number of matches with a productivity z entrepreneur and the denominator is the total number of matches.

The problem of the constrained social planner is given sequentially by

$$\begin{aligned} & \max_{\{c_t, a'_t, s_t, \theta_t, m_t\}_{t=0}^{\infty}} \sum_{t=0}^{\infty} \beta^t \int \int \int u(c_t) m_t(a, z) j(y) dy da dz \\ & \text{s.t. } a'_t + c_t = Ra_t + (1 - s_t)y + s_t(w_t(z) - (1 - z)b) \quad \forall a, y, z \\ & \quad a_{t+1} \geq 0 \\ & \frac{v(m_t, \eta_t, \eta_{t+1}, g_t)}{\theta_t} = \int \int s_t(a, 0) m_t(a, 0) j(y) dy da \\ & \quad m_{t+1}(a'_t, 0) = m_t(a, 0) - \theta_t p(\theta_t) \int s_t(a, 0) m_t(a, 0) j(y) dy \\ & \quad m_{t+1}(a'_t, z) = (1 - \tilde{\lambda}) m_t(a, z) + H(z, m_t, \eta_t, \eta_{t+1}, g_t) \theta_t p(\theta_t) \int s_t(a, 0) m_t(a, 0) j(y) dy \end{aligned} \quad (20)$$

where the functions η_t and g_t arise from the slightly modified sequential problem

of an entrepreneur:

$$\begin{aligned}
& \max_{\{d_t, f_{t+1}, k_t, n_t, v_t\}} \sum_{t=0}^{\infty} (\beta \Delta)^t \frac{c_t^{1-\sigma}}{1-\sigma} \\
& s.t. \quad d_t + f_{t+1} = (1-\chi) z k_t^\alpha n_t^{1-\alpha} - (r+\delta) k_t - (1-\chi) \underline{w} n_t + f_t - c v_t \\
& \quad n_{t+1} = (1-\lambda) n_t + p(\theta_t) v_t \\
& \quad k_t \leq \gamma f_t \\
& \quad f_0 \in \mathbb{R}
\end{aligned} \tag{21}$$

so that $\eta_t = \frac{\gamma f_t}{n_t}$ and $g_t = \frac{f_{t+1}}{f_t}$.

Note that here I have imposed the scale-invariance of the entrepreneurs optimal capital-labor ratio and growth rate and left the initial condition f_0 arbitrary. In analysis of the problem of the social planner, it will be useful to note that while η_t and g_t are potentially functions of z and the entire sequence of labor market tightness $\{\theta\}_{t=0}^{\infty}$, solving the entrepreneur's problem reveals that they depend only on ability z and current and future tightness θ_t, θ_{t+1} and thus can be written as $\eta_t(z, \theta_t, \theta_{t+1})$ and $g_t(z, \theta_t, \theta_{t+1})$. The independence of entrepreneur policy functions from values of θ beyond period $t+1$ follows directly from the linearity of the hiring cost, combined with the parameter assumptions that ensure that any operating entrepreneur will choose $v_t > 0$ each period. While the continuation value of an entrepreneurs labor force depends in theory on the whole sequence of labor market tightness, the ability to re-optimize at linear cost tomorrow ensures that this continuation value is equal to the "liquidation value" of the workforce next period.

3.1. Notes and Proof for Proposition 2

The dynamic terms in equation 17 are given by

$$\begin{aligned}
& \text{Anticipation Terms} = \\
& \frac{S}{\bar{\theta}} \left(\mu_{t-2} \left(\frac{\partial v_{t-2}}{\partial \eta_{t-1}} \frac{\partial \eta_{t-1}}{\partial \theta_t} \right) + \mu_{t-1} \left(\frac{\partial v_{t-1}}{\partial \eta_{t-1}} \frac{\partial \eta_{t-1}}{\partial \theta_t} + \frac{\partial v_{t-1}}{\partial \eta_t} \frac{\partial \eta_t}{\partial \theta_t} \right) + \mu_t \left(\frac{\partial v_t}{\partial \eta_t} \frac{\partial \eta_t}{\partial \theta_t} \right) \right) + \\
& \bar{\theta} p(\bar{\theta}) S \left(\int_z \lambda_{t-2}(z) \left(\frac{\partial H_{t-2}}{\partial \eta_{t-1}} \frac{\partial \eta_{t-1}}{\partial \theta_t} \right) dz + \int_z \lambda_{t-1}(z) \left(\frac{\partial H_{t-1}}{\partial \eta_{t-1}} \frac{\partial \eta_{t-1}}{\partial \theta_t} + \frac{\partial H_{t-1}}{\partial \eta_t} \frac{\partial \eta_t}{\partial \theta_t} \right) dz + \right. \\
& \left. \int_z \lambda_t(z) \left(\frac{\partial H_t}{\partial \eta_t} \frac{\partial \eta_t}{\partial \theta_t} \right) dz \right)
\end{aligned} \tag{22}$$

where μ_t and $\lambda_t(z)$ are the shadow prices associated with the constraints on aggregate labor market tightness and productivity-specific matching rates respectively. These terms essentially capture the welfare gains from anticipatory hiring when labor market tightness is changed. Essentially, while the welfare changes from permanent changes in hiring are captured in the other terms of equation 17, this term captures the small gains that occur due to the fact that some of this hiring is done in anticipation of the change, shifting some hiring forward temporally.