



# Entrepreneurship and government subsidies: A general equilibrium analysis<sup>☆</sup>

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## Abstract

This paper quantitatively studies the effects of government credit subsidies. We find that current credit assistance programs in the form of interest subsidies exert strong effects on the allocation of credit to targeted entrepreneurs, but at the cost of non-targeted entrepreneurs. Total entrepreneurial activities are reduced and large output loss is incurred. The paper also examines several alternative credit programs. Our analysis suggests that income subsidy programs and programs that specifically target poor and capable entrepreneurs are more effective in promoting entrepreneurial activity and improving total output. These findings are based on a model with a large number of infinitely lived agents whose saving behavior and occupational choice are influenced by precautionary saving motives and borrowing constraints. Government credit subsidies, on the benefit side, enhance the liquidity of agents by providing an additional means of smoothing consumption and by effectively loosening borrowing constraints. On the cost side, these subsidies and resulting taxes crowd out capital and have adverse incentive effects. Crown Copyright © 2002 Published by Elsevier Science B.V. All rights reserved.

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## 1. Introduction

The U.S. government plays a central role in promoting entrepreneurship in the United States. Every year, billions of dollars are put into the business community through the Small Business Administration (SBA).<sup>1</sup> The level, time path, and type of government subsidy are obviously important issues in credit policy. In this paper, we analyze the quantitative effects of government subsidies on business credit allocation and economic efficiency, and contrast the results of the current program with alternative programs that use different credit instruments or different targeting rules. The analysis is conducted with a model parameterized to match various features of the U.S. economy. Under our parameterization, we find that the current interest subsidy has large allocational effects. This program greatly increases entrepreneurial activity of the targeted group, albeit at the expense of the non-targeted group. The net result is a reduction in the rate of total entrepreneurship. The efficiency cost is also high: output is about 0.62 percent lower than that under the optimal subsidy rate and 0.52 percent lower than that of the zero subsidy case. Finally, our analysis of alternative credit programs indicate that income subsidies and programs that target specifically poor and capable entrepreneurs are more efficient in promoting entrepreneurship and total output than the current practice.

The belief that capital markets do not provide adequate funds for businesses, particularly new businesses, is the main rationale for government assistance programs. Recent empirical studies lend support to this belief. Evans and Jovanovic (1989), Evans and Leighton (1989), Holtz-Eakin et al. (1994), and Blanchflower and Oswald (1998), among others, find that a lack of wealth affects people's ability to become self-employed, even after accounting for the possible correlation between entrepreneurial ability and wealth. In a more recent study, Bond and Townsend (1996) reported the results of a survey of financial activity in a low-income, primarily Mexican neighborhood in Chicago and found that borrowing is not an important source of finance for business set-ups. In their sample, only 11.5 percent of business-owners financed their start-up with a bank loan, while 50 percent of the respondents financed their start-up entirely out of their own funds. Other authors (see, for example, Carpenter et al., 1994) find evidence of significant capital market imperfections even for publicly traded manufacturing companies.

A relevant model for our purpose, therefore, is one with capital constraints, and one where agents in the economy endogenously make their occupational decisions. The model used here consists of a large number of infinitely lived

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<sup>1</sup> In December 1997, with the growing popularity of SBA loans, Congress passed an SBA funding bill that set aside \$39.5 and \$11 billion, respectively, for the SBA's 7(a) and 504 business loan programs over the next three years. This more than tripled the current 7(a) level which was \$10.3 billion in fiscal year 1997 (Bureau of National Affairs, Inc. 1997).

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