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# Occupational choice, incentives and wealth distribution<sup>☆</sup>

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## Abstract

We consider a model of occupational choice in large economies where individuals differ in their wealth endowment. Individuals can remain self-employed or engage in productive matches with another individual, i.e., form firms. Matches are subject to a moral hazard problem with limited liability. The division of the gains from such matches is determined by competitive forces. When the incentive problem is asymmetric, matches are typically wealth-heterogeneous, with richer individuals choosing the occupation for which incentives are more important. The utilities attained within a match depend on the wealth distribution and changes in the latter give rise to ‘trickle down’ effects.

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## 1. Introduction

How do incentives affect the relation between the distribution of wealth and the occupational decisions, matching patterns and payoffs that obtain in decentralized markets? We study this question for economies with asymmetric tasks in production and limited wealth transferability within matches.

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Our economies consist of a large number of risk-neutral individuals with different wealth endowments. Individuals may match together for production in contractual pairs that we will refer to as ‘firms’, or ‘partnerships’. These matches are subject to a moral hazard problem with limited liability (i.e., non-negative final wealth) constraints. Each partner can take one of two occupations (or ‘jobs’, or ‘tasks’, or ‘roles’) that differ in how the unverifiable component of effort affects the probability of success of the economic activity. Contracts within a match specify a distribution of the gains from production given an allocation of jobs to the parties, taking into account the parties’ reservation utilities or what they can earn in other matches and occupations. In equilibrium, the expected payoff for each partner in each occupation and match is equal to the reservation utility and the demand for jobs in the economy equals the supply.

Since roles have different productivities, equilibrium contracts should force incentives upon the individual in the more productive role. Surplus division then implies that this individual pays a transfer to the other party, and only *his* limited liability constraint can bind. When it does bind, there is a tension between maximization of the (incentive compatible) surplus and its division, and wealth effects arise. A threshold wealth level separates the individuals into two classes, with richer individuals choosing the occupation for which effort is more productive and incentives more important.

Wealth effects are pinned down by the wealth level of the poorest individual in the more productive job. The wealth level of this individual (corresponding to the median of the wealth distribution), affects the aggregate demand and supply of different occupations and determines the return to these occupations for each individual. Changes in the distribution that alter the median create trickle down effects by changing these returns. An increase in the median wealth makes rich individuals relatively abundant, making individuals above the median worse off and all those below better off.

Wealth effects are absent when, for example, all individuals are rich enough to afford the transfer that allows equal division of the maximum incentive compatible surplus. As a result, net payoffs are equalized across occupations and types, segregation or type-homogeneous matching is an equilibrium, and the wealth distribution does not matter for utilities. In the special case where the incentive problem is completely symmetric (i.e., occupations identical) no transfers are necessary to achieve equal division of the maximum surplus. Consequently, wealth effects never arise and segregation is always an equilibrium.

Our results depend on the interaction between the indivisibility of tasks, the related asymmetry in incentives across occupations, and two different wealth transferability problems. The first arises from the above-mentioned limited liability constraints on the ex-post division of the surplus. Non-convexities and inefficiencies due to limited liability and asymmetries can be eliminated if the individuals can commit to ex-ante surplus division schemes such as lotteries on occupations.<sup>1</sup> As long as participation constraints need bind only in expected terms over lottery

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<sup>1</sup>As in [14].

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