Accepted Manuscript

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PII: S0304-4068(18)30034-X
DOI: https://doi.org/10.1016/j.jmateco.2018.03.004
Reference: MATECO 2227

To appear in: *Journal of Mathematical Economics*

Received date : 20 March 2016
Revised date : 17 October 2017
Accepted date : 12 March 2018

Please cite this article as: Vachadze G., Credit market imperfection, minimum investment requirement, and endogenous income inequality. *Journal of Mathematical Economics* (2018), https://doi.org/10.1016/j.jmateco.2018.03.004

Credit Market Imperfection, Minimum Investment Requirement, and Endogenous Income Inequality

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March 24, 2018

Abstract

The main goal of this paper is to describe an endogenous feedback mechanism through which imperfection in the credit market may amplify income inequality. When entrepreneurs are subject to a minimum investment requirement and entrepreneurs' future revenue is not fully pledgeable for debt repayment, then the highest interest rate entrepreneurs can credibly offer to depositors depends not only on the marginal product of capital but also on entrepreneurs' net wealth. This dependence creates an entrepreneurial rent which has both direct and indirect impacts on income inequality. On the one hand, entrepreneurial rent magnifies income inequality because it changes the balance between marginal product on capital (collected by entrepreneurs) and the interest rate (collected by depositors) and alters young agents saving decision. Entrepreneurial rent indirectly affects the labor income inequality because it distorts young agents' labor supply decision and thus indirectly affects labor income earned by borrowers and lenders. Under some configuration of parameter values, the model predicts a Kuznets curve, i.e., an inverted-U relationship between per capita income and income inequality.

Keywords: Credit market imperfection, income inequality, Kuznets curve

JEL Classification: D63; E44; J22; O16

*I am indebted to two anonymous referees and the associate editor for their constructive and valuable comments. I also benefited from comments and suggestions made by Linda Coull, Thomas Hauner, Richard Nugent, and Bryan Weber. This work was supported by Provost's Research Scholarship Award and City University of New York PSC-CUNY Research Award TRADA-46-127. Department of Economics, College of Staten Island and Graduate Center, City University of New York, Staten Island, NY 10314. E-mail: george.vachadze@csi.cuny.edu