

Financial Frictions, Occupational Choice and Economic Inequality

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Abstract

We develop a quantitative life-cycle theory of occupational choice decisions, economic inequality, and financial frictions. The model is calibrated to life-cycle evidence on occupational choices and their persistence, earnings inequality, and consumption inequality in the Brazilian data. An important novelty of our theory is that individuals are heterogeneous in *two* ability types – ability as a worker and ability as an entrepreneur. Depending on their comparative advantage at occupations (ratio of abilities) and wealth, individuals may choose to become workers or entrepreneurs. The correlation of these two abilities is important for the quantitative implications of the theory because it determines the extent to which talented entrepreneurs are able to self-finance their businesses. When the correlation between skills is high, individuals that are talented as entrepreneurs are also talented as workers. Then, if skills are also persistent over time, young and talented individuals can work when young, build savings, and use their savings to finance their businesses when old. Thus, when entrepreneurial and working skills are highly correlated and persistent over time, the effects of financial frictions on resource allocations are less important than otherwise. Through counterfactual exercises, we want to study how alternative ways of generating economic inequality matter for the effects of financial frictions in the economy. We expect these results to deepen our understanding of the (non-trivial) interactions between inequality, financial frictions, and economic development.

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