

DISSERTATION PROPOSAL

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“Essays on Macroeconomics”

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In my dissertation, I focus on understanding the adverse effects of market and behavioral frictions on firm/entrepreneurial growth and welfare. I use a quantitative-model based approach and show that corporate diversification strategies, over-borrowing are adequate mechanisms to reduce the effect of these frictions.

In the first chapter, I determine whether the organizational structure of firms alleviates the effect of market frictions in developing countries. In this paper, I empirically and theoretically establish that capital misallocation is lower across business-group firms than across stand-alone firms. Business groups are an important organizational structure in most developing countries. I first propose a method which extends the identification approach of Hsieh and Klenow (2009) to a dynamic framework and identifies mean investment distortions from firm-level data. I apply this scheme on a panel of manufacturing firms in India. I find that mean distortions are lower for large business-group firms than large stand-alone firms and are increasing with firm size. Business-group firms also display lower cross-sectional dispersion in capital revenue productivity (marginal product of capital) over the entire sample period. In order to interpret these findings, I develop and estimate a two-sector model of firm dynamics in which firms choose their organizational structure, face investment irreversibility and financing frictions. Using the model, I show that capital reallocation and cashflow diversification within business groups translate into lower investment distortions, lower dispersion for group-affiliated firms.

In the second chapter, using cross-country data for 45 countries, I show that business group firms are more prevalent in countries with more stringent job protection provisions. This relation is robust to the inclusion of country-level governance, financial development indicators and other potential determinants of business group formation. To reconcile these empirical findings, I propose a general equilibrium model of firm dynamics in which firms choose their optimal employment policies and their decision to form a business group. I calibrate the model using realistic parameter values and study the effect of two types of job protection policies on the stationary equilibrium: (i) size independent and (ii) size dependent firing costs.

In the third chapter, I analyze the distortionary effect of time inconsistent preferences on the investment behavior of poor entrepreneurs. The specific form of time inconsistency that I consider is the quasi-hyperbolic discounting structure. I develop a model in which an entrepreneur is characterized by her degree of present bias i.e. her quasi-hyperbolic discount

factor and chooses to execute a lumpy investment decision by borrowing from a non-profit Micro Finance Institution (MFI). Using the model I show that if the entrepreneur is sufficiently patient, she optimally borrows and invests. However, if she is impatient, she is seen to undergo preference reversals and uses the microcredit for consumption rather than investment. A sophisticated entrepreneur recognizes this lack of self-control beforehand and over-borrows ex-ante to discipline her future investment behavior. I then characterize the profit-maximizing credit contract that is offered to a naive entrepreneur by a for-profit MFI and determine whether it disciplines her investment incentives. I finally determine the welfare consequences of these credit contracts for the entrepreneur relative to financial autarky.