Lack of Selection and Imperfect Managerial Contracts: Firm Dynamics in Developing Countries*

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July 29, 2014

Abstract

Firm dynamics in poor countries show striking differences from those in rich countries. While some firms indeed experience growth as they age, many firms are simply stagnant in that they neither exit nor expand. We interpret this fact as a lack of selection, whereby producers with little growth potential survive because firms with the potential to innovate do not expand enough to force them out of the market. Our theory stresses the role of imperfect managerial contracts. If the provision of managerial effort is non-contractible, firms will endogenously limit managerial authority to reduce the extent of hold-up. In larger companies, the contractual frictions create larger hold-up problems. This generates a disincentive to become a large firm. Improvements in the degree of contract enforcement will therefore raise the returns to growing large and increase the degree of creative destruction; innovative firms will replace inefficient producers quicker. To quantify the importance of this mechanism, we build an endogenous growth model with incomplete managerial contracts and calibrate it to micro data from India. Improvements in the contractual environment can explain a sizable fraction of the difference between the life-cycle of plants in the US and in India. The model also suggests that policies targeted toward small firms could be detrimental to welfare as they slow down the process of selection.

Keywords: Development, growth, selection, competition, firm dynamics, contracts, management, entrepreneurship.

JEL classification: O31, O38, O40

*We thank the seminar and conference participants at the Productivity, Development & Entrepreneurship, and Macroeconomics Within and Across Borders Meetings at the NBER Summer Institute, LSE, London Macroeconomics Conference, Cologne Workshop on Macroeconomics, SKEMA Growth Conference, and UPenn Growth Reading Group for helpful comments, and Nick Bloom, Francesco Caselli, Matthew Cook, Jeremy Greenwood, John Haltiwanger, Chang-Tai Hsieh, Daniel Keniston, Pete Klenow, Sam Kortum, Aart Kraay, Rasmus Lentz, Giuseppe Moscarini, Luis Serven, Yongs Shin, and Silvana Tenreyro for very valuable feedback. Chang-Tai Hsieh and Pete Klenow have kindly provided some of their data for this project. Akcigit gratefully acknowledges financial support from the World Bank.

1 Introduction

Firms in poor countries are much smaller than those in rich countries. This is due to differences in life-cycle growth. More specifically, it is not the case that firms in rich countries enter at a much bigger size, but rather that they grow as they age (Hsieh and Klenow (2011)). In this paper, we argue that this difference is due to a lack of selection in poor countries. While firms in poor countries indeed do not grow on average, this average hides an important regularity: Although there are producers that grow over their lifetime, the vast majority of firms are simply stagnant in that they neither exit nor expand. In fact, this dichotomy between innovators and stagnant firms is not limited to developing countries. As shown by Hurst and Pugsley (2012) there are also many firms in the US that do not expand. The striking difference between poor and rich countries, however, is their aggregate importance. While such firms in the US account for relatively little aggregate employment and shrink in importance as they age, in poor countries essentially the entirety of employment is allocated toward these producers and their aggregate importance remains stubbornly high. The problem in developing countries therefore seems not to be a failure of most firms to grow. The problem is rather that firms that do have innovative potential do not grow quickly enough to push stagnant producers out of the market. This paper provides both a theory of and empirical evidence from the Indian manufacturing sector for this lack of selection.

Why is the degree of creative destruction, whereby innovative firms replace stagnant firms, so low in India? We focus on one particular mechanism, namely, frictions in the market for managers. If managers add value to the firm by increasing its profitability, inefficiencies in how managerial services can be provided will lower the return to growth and thereby reduce the competitive pressure on stagnant firms. The idea that managerial inputs are crucial for the process of firm dynamics has a long tradition in development economics. Of particular importance is the seminal work of Penrose (1959), who argues not only that managerial resources "create a fundamental and inescapable limit to the amount of expansion a firm can undertake at any time" but also that it is precisely this scarcity of managerial inputs that prevents the weeding out of small firms as "the bigger firms have not got around to mopping them up" (Penrose (1959, p. 221)). Recently, a series of papers by Bloom and Van Reenen have provided empirical support for this view. First, they show that managerial practices differ across countries (Bloom and Van Reenen (2007, 2010)). Second, they suggest that it is not merely differences in managerial technology (or human capital) that determine managerial efficiency, but that contractual imperfections are likely to be at the heart of why firms in poor countries might be "management constrained." In their empirical study of Indian textile firms, they find that "managerial time was constrained by the number of male family members. Non–family members were not trusted by firm owners with any decision-making power, and as a result firms did not expand beyond the size that could be managed by close (almost always male) family members" (Bloom et al. (2010)).

We embed these features into an otherwise standard endogenous growth model in the tradition of Klette and Kortum (2004). We model firm dynamics as the outcome of creative destruction, whereby firms expand into new product lines by investing in productivity-enhancing activities. To study the importance of selection, we allow for two types of firms. While innovating firms have the potential to grow by investing in technological improvements, stagnant firms are endowed with an inefficient innovation technology, which makes them remain small. Managerial effort is an input into the production technology. To analyze the consequences of imperfect managerial contracts, we model the strategic interaction between managers and firm owners as an incomplete contracting game as in Grossman and Hart (1986) and Acemoglu et al. (2007).

In particular, we assume that the provision of managerial effort is non-contractible and that

the manager and the firm bargain over the joint surplus ex-post. To limit managerial hold-up, the firm can decide to monitor some of the manager's actions. Doing so allows the firm to enforce the provision of effort in those tasks. We will loosely refer to this choice of monitoring as the firm's allocation of authority. While monitoring is valuable ex-post, as it increases the firm's bargaining share, it is detrimental to efficiency in that it lowers the manager's incentive to provide effort ex-ante. The crucial prediction of the theory is that the incentives for monitoring are higher for larger firms than for smaller firms. Intuitively, as firms with larger revenue face a more severe hold-up problem in the bargaining stage, their incentives to distort the provision of managerial effort on the margin increase. Contractual imperfections lead to a schedule of marginal costs that are endogenously *increasing* in firm size. From a dynamic point of view, firms anticipate that the marginal costs of production increase as they expand. The value of growing large is low when contractual imperfections are severe. This in turn lowers innovation incentives for innovating firms and, with it, the degree of creative destruction. Contractual frictions therefore limit the process by which innovators "mop up" stagnant producers.

After characterizing the dynamic equilibrium of our model, we take it to the data and calibrate its structural parameters to the Indian establishment-level data. Our model matches the targeted moments well. In order to understand the quantitative importance of contractual frictions, we recalibrate the model to US data by varying the parameters that drive contractual frictions and the type distribution of entrepreneurs. Then we conduct the following counterfactual exercise: we replace the contractual environment in India with its US counterpart while keeping all other parameters fixed. Our analysis uncovers the following facts: First, the model is able to explain 60% of the observed differences in firm dynamics between the US and India. Second, managerial practices account for more than 50% of the difference. In addition, the improved creative destruction leads to a 50% reduction in the number of low-type firms in the economy within the first 15 years of their lifetime. Finally, the share of total employment by firms of 10-year and older increases from 6% to 90%. Overall, these results show that the contractual frictions can potentially go a long way toward explaining the differences in firm selection and creative destruction.

Related Literature This paper provides a theory of firm dynamics in developing countries.[1] While many recent papers have aimed to measure and explain the static differences in allocative efficiency across firms,[2] there has been little theoretical work explaining why firm dynamics differ so much across countries. A notable exception is the work by Cole et al. (2012), who argue that cross-country differences in the financial system will affect the type of technologies that can be implemented. Like them, we let the productivity process take center stage. However, we turn to the recent generation of micro-founded models of growth, in particular Klette and Kortum (2004). While such models have been built to study firm dynamics in developed economies (Lentz and Mortensen (2005, 2008), Akcigit and Kerr (2010), Acemoglu et al. (2012)), this is not the case for developing countries.[3] We believe endogenous technical change models are a natural environment for studying this question, as they focus on firms' productivity-enhancing investment decisions. We believe that models of endogenous growth have been under-utilized in the development literature,

[1] An overview of some regularities of the firm size distribution in India, Indonesia and Mexico is contained in Hsieh and Olken (2014).

[2] The seminal papers for the recent literature on misallocation are Restuccia and Rogerson (2008) and Hsieh and Klenow (2009). As far as theories are concerned, there is now a sizable literature on credit market frictions (Buera et al., 2011; Moll, 2010; Midrigan and Xu, 2010), size-dependent policies Guner et al. (2008), monopolistic market power (Peters, 2013) and adjustment costs (Collard-Wexler et al., 2011). A synthesis of the literature is also contained in Hopenhayn (2012) and Jones (2013).

[3] An exception is Peters (2013), who applies a dynamic Schumpeterian model to firm-level data in Indonesia.

partly because of a lack of data to discipline these models, and partly because early models of endogenous growth have been mainly constructed to model innovation decisions of firms in developed countries.[4] Hence, these early models have been harmonized with terminologies such as innovation, R&D, patent protection, and innovation policy, which do not seem to properly capture the reality of firms in developing countries. For the remainder of this paper, we therefore refer to innovation in a broad sense, capturing not only the implementation of new ideas but also a variety of costly productivity-enhancing activities, encompassing also training, reorganization or the acquisition of high-quality complementary factors.

We focus on inefficiencies in the interaction between managers and owners of firms to explain the differences in firms' demand for expansion. Hence, particularly relevant contributions are Caselli and Gennaioli (2012) and Powell (2012). Caselli and Gennaioli (2012) also stress the negative consequences of inefficient management. Their focus is on the efficiency of the "market for control", i.e., the market where (untalented) firm owners are able to sell their firms to (talented) outsiders. With imperfect financial markets, such transactions might not take place as outsiders might be unable to secure the required funds.[5] Our economy does not have any exogenous heterogeneity in productivity so that there is no notion of *static* misallocation. In contrast, we argue that managerial frictions *within* the firm reduce growth incentives and hence prevent competition from taking place sufficiently quickly on product markets. Such within-firm considerations are also central in Powell (2012), who studies an economy where firms ("owners") need to hire managers as inputs to production but contractual frictions prevent owners from committing to pay the promised managerial compensation after managerial effort has been exerted. He studies the properties of the optimal long-term relational contract in a stationary equilibrium, whereby owners are disciplined to keep their promises through reputational concerns. There are two important differences from our paper. First, Powell (2012) studies an economy where firm productivity is constant, i.e., there is no interaction between contractual frictions in the market for managers and firms' innovation incentives. Second, while he studies the implications of *owners* not being able to write contracts on their wage promises, we focus on *managers* not being able to contractually commit themselves to their choice of effort. This difference is important in that it determines the distribution of costs of imperfect legal systems. While in our model, contractual frictions will especially hurt *large* firms, for which hold-up is costly, Michael Powell's model implies that *small* producers will be particularly affected, as they have little reputational capital to pledge.

The remainder of the paper is organized as follows. The next section presents evidence on the two main ingredients of our theory. In particular, we present three regularities of managerial employment across countries and use Indian micro data to show the importance of our assumption on innovating and stagnant firms. In Section 3 we describe the theoretical model. Section 4 contains the quantitative analysis. We first calibrate the model to the Indian micro data and then consider the two policy exercises discussed above. Section 5 concludes.

[4] A major impediment to bringing the first-generation models of endogenous growth to the data is that these were aggregate models, which do not have direct implications at the firm level (Romer, 1990; Aghion and Howitt, 1992; Grossman and Helpman, 1991).

[5] Another reason for untalented owners to *not* sell their firm is that individual wealth can substitute for managerial incompetence if financial markets are imperfect. Hence, financial frictions will also reduce the supply of firms and not only the demand from credit-constrained outsiders.

2 Motivating Evidence

This paper proposes a theory of firm dynamics in developing economies. The theory has two main ingredients. First, we argue that it is important to think of the economy as being populated by different *types of firms*. Some innovate, and some remain in the market without expecting to grow. Second, we link the speed at which the market is able to drive stagnant firms out of the market to contractual frictions between managers and entrepreneurs. In this section, we present some evidence on both of these ingredients. This not only aims to motivate the environment we have in mind, but we will also use some of these regularities as explicit calibration targets in our quantitative exercise.

2.1 Innovators and Stagnant Firms in India: Empirical Evidence

In this section, we present micro evidence on the pervasiveness of stagnating firms in the Indian economy. To get a picture of the population of Indian firms, we follow Hsieh and Klenow (2011) and Hsieh and Olken (2014) to construct a firm-level data set by merging the Annual Survey of Industries (ASI) and the National Sample Survey, Schedule 2.2 (NSS). Broadly speaking, the ASI contains the universe of establishments with more than 100 employees and a random sample of establishments with 20 to 100 employees. The NSS is a survey of informal establishments. Using this information we extrapolate to the whole economy using the sampling weights provided in the data. A more detailed description of the data is given in Section 4.

As in Hsieh and Klenow (2011) we focus mainly on the cross-sectional size-age relationship and interpret this schedule as the life-cycle of a representative cohort. This will be exactly true in our theory. In general, the cross-sectional pattern could be driven by cohort effects and not be informative about the life-cycle. While we could look at the firm dynamics more directly using the panel version of the ASI data, the NSS data are only available in repeated cross-sections every five years; we focus on the cross-section for now but refer to it as the life-cycle.[6]

For comparison with the literature, we first want to ensure that we are able to replicate other findings in the literature. First, we focus on the firm-size distribution and replicate the findings of Hsieh and Olken (2014). We report these results in Section 6.2 in the Appendix. Second, we focus on the life-cycle of manufacturing plants in India. In Figure 1 below we first replicate the findings of Hsieh and Klenow (2011) using our data. In particular, we calculate mean employment for different age bins and plot average firm size by age relative to the size of the youngest cohort, which we will sometimes refer to as entrants. As in Hsieh and Klenow (2011) we see little growth along the life-cycle. For ease of comparison, we chose the axis to approximately represent the growth of typical firms in a developed economy, which is roughly equal to five.

Figure 1 can be driven by two types of theories. It could either be the case that the representative Indian firm grows less than its US counterpart. Or it could be the case that the flat average profile in India is driven by a plethora of firms, which do not grow at all, while some innovative firms actually do grow — there are just too few of them in the aggregate to affect the average age-size relationship in a meaningful way. As explained above, we opt for the second explanation: the *selection hypothesis*. In what follows, we are going to decompose Figure 1 in various ways to show that this is indeed a useful look at the data: There are growing firms in India, but they do not grow sufficiently quickly to force the stagnant firms to exit the market.

As a first cut of the data, we analyze the ASI and NSS data separately. This is problematic

[6] We could, of course, follow Hsieh and Klenow (2011) and construct the synthetic life-cycle from the comparison of repeated cohorts in different years of the sample. We have not explored this in detail yet.

because being in one of the samples is not a fixed firm characteristic, but to a large degree a function of size. The split is nevertheless useful because it is a transparent decomposition of the data. In Figure 2 we plot the life-cycle for the two different samples. The differences are apparent: While there is growth along the life-cycle for plants in the ASI, there is no growth for firms in the NSS.

Interpreting Figure 2 is not straightforward due to selection into the ASI. Specifically: Growing firms will leave the NSS and migrate into the ASI as they formalize and cross the size threshold of 20 employees. However, given that the vast majority of firms in the NSS are far from the threshold (the median firm has 2 employees, and the 99% quantile is 13 employees), we think it is unlikely these transitions account for the majority of the differences in the age-size relationship.[7] However, we will nevertheless look at cuts of the data that are less subject to these concerns.

If the Indian economy is characterized by a small number of innovative firms, we expect the firms to be bigger at a point in time and, more important, to actually increase their importance as they age. The intuition is that if only the best firms grow, the distribution of firm size should "fan out" in the upper tail relative to the rest of the economy. The data indeed reflect this.

Figure 3 plots the life-cycle of the top 5% of firm observations in each age group. More specifically, we take the top 5% of observations — from the entire sample consisting of ASI and NSS firms — and track their average employment as they age. The results mirror our findings in Figure 2: The top firms in India actually do grow quite substantially. The average employment of the top 5% increases by a factor of 6. Hence, it is not the case that the Indian manufacturing sector is stagnant; the majority of firms are, but there are vibrant pockets that do expand with age. One comment about Figure 3 is in order. To construct the figure we chose the top 5% of observations in the data. These 5% of observations account for less than 5% of firms because small firms (primarily in the NSS) get a higher sampling weight than do bigger firms (primarily in the ASI). If bigger firms have lower sampling weights as they age, we might be selecting fewer and fewer firms by focusing on the top 5% of observations. In Section 6.3 in the Appendix we perform various robustness checks to Figure 3, which give the same answer qualitatively.

Finally, we look at one particular firm characteristic that is easily observable and argued to be an import dimension of heterogeneity: family firms. Both the NSS and ASI identify whether firms are organized within a family, i.e., if family members hold the property rights to the firm. Figure 4 below performs the life-cycle exercise for the subsample of family and non-family firms. Again, the importance of that characteristic is striking: While family firms do not grow as they age, firms outside the scope of the family increase employment by a factor of 6.

None of the exercises displayed in Figures 2, 3 and 4 is perfect, and these are not mutually exclusive, as these samples are correlated: The top firms are likely to come from the ASI and are in turn less likely to be family run. Also, a firm's family status is obviously not a "stamp on the head" of the firm, but an endogenous choice of the owner. This endogeneity is, however, at the heart of our argument that the substantial problem of the Indian economy is one of selection. While some firms manage to expand in the Indian business environment, these firms are too few in the aggregate to draw resources from the stagnant firms of the economy sufficiently quickly to force these firms to exit.

To see this lack of selection in the micro data, finally consider Figure 5, which shows the share of firms with at most 2 workers by age. Roughly 70% of firms fall into this category. More notably, this share is almost constant by age. Hence, these firms - which are probably run by an owner and another family member - neither exit the economy nor grow out of these family boundaries. From

[7] To reconcile Figures 1 and 2, note that only roughly 1% of firms are part of the ASI. Hence, the aggregate picture (Figure 1) is dominated by the behavior of NSS firms, which do not grow. See Figure 25 in the Appendix, which plots the share of firms in the ASI as a function of age.

	Share of firms with fewer than 20 employees		
	0-10 Years Old	10-25 Years Old	Full Sample
U.S (2005)	85.5	71.5	72.4
India (1995)	99.3	99.5	99.6
	Share of aggregate employment in firms with fewer than 20 employees		
	0-10 Years Old	10-25 Years Old	Full Sample
U.S (2005)	34.6	16	8.5
India (1995)	81.6	76.2	74.5

TABLE 1: IMPORTANCE OF SMALL FIRMS ACROSS AGE: US VERSUS INDIA

a literal life-cycle interpretation, Figure 5 suggests that the majority of entrepreneurs in India start a firm with two employees and remain at this size for their entire life. While we do not have access to the US micro data to redo the same exercise, Table 1 reports the data about small firms from Hurst and Pugsley (2012) and compares them with our Indian data.

Small firms are defined as firms with fewer than 20 employees. What we find notable is the difference in selection. While the aggregate importance of small firms in the US drops by more than 50% as the cohort ages (i.e. it drops from 34.6% to 16%), the corresponding number in India drops only by 5% (from 81.6% to 76.2%). This is because large firms are larger in the US, and because small firms do not exit in India.

To understand the aggregate evolution of the manufacturing economy, one has to understand (a) why innovative firms do not grow enough to force inefficient firms out of the market, and (b) why there is such prevalent entry of firms that neither grow nor exit. The first aspect concerns the innovation incentives of potential innovators, and the second aspect concerns the apparently low opportunity costs of stagnant producers. In this paper, we will provide a model that formalizes these two margins by introducing imperfect contracts in the relationship between owners and managers.

2.2 Imperfect Contracts and Managerial Employment

Our focus on the linkage between the cross-country variation in the state of the contractual environment and the interaction between owners and managers is partly determined by three broad macro facts, which are depicted in Figure 6 below. In the left panel, we depict the cross-sectional relationship between the country-wide employment share of managerial personnel and the "rule of law" Index of the World Bank in 2010. It can clearly be seen that there is a robust positive correlation in that better governance leads to an increase in the provision of managerial positions. In the right panel, we show the cross-sectional correlation of the rule of law index and the importance of self-employment. As expected (and consistent with Gollin (2008)), there is a strong negative correlation in that petty entrepreneurship seems to flourish in bad legal systems. Finally, the last panel uses the data from Bloom et al. (2009) on within-firm decentralization and shows that countries with better legal systems see more decentralization in that more decision power is granted to plant managers.

Our theory will (a) connect these three facts and (b) show why (and how) these regularities are predictive of sclerotic selection as shown in Section 2.1. Our basic narrative is the following: In our theory, owners and managers interact in a process of joint production. If contracts are imperfect, owners are subject to managerial hold-up. In response, owners will endogenously limit managerial authority (Fact 3). Such limits to authority, however are costly as they reduce managerial effort and with it firm profitability. Hence, they lower firms' demand for managers and consequently the equilibrium level of managerial personnel (Fact 1). Moreover, as far as innovation incentives

are concerned, reduced profitability is akin to a scale effect from the point of view of the firm: Contractual frictions reduce innovation incentives for high types so that low types will survive longer as there is little threat of creative destruction. As small firms will be predominantly low types and smaller firms are (in our theory) less likely to hire managers from outside and hence more likely to be self-employed entrepreneurs, contractual frictions will drive up the rate of self-employment (Fact 2).

An important implication of the micro data is that some firms in India will be *managerially constrained,* in that contractual frictions between owners and managers cause an effective under-supply of managerial resources. The selection hypothesis implies that the problem in India is not so much that small firms do *not* grow but that big firms do not grow *even more*. Hence, the marginal product of managerial resources should be especially high for large firms. In Figure 7 we plot the non-parametric regression of the *average* product of managers, that is, the log of the value added per manager as a function of firm size.[8] Hence, as long as the average product carries information about the marginal product (which it will in our theory), Figure 7 suggests that the marginal value of managerial efficiency units is particularly high in large firms, i.e., it is precisely large firms that seem to be constrained on the managerial margin.[9] This cross-sectional relationship between size and the marginal products will be informative about the degree of contractual frictions. Hence, we will use it as an explicit micro-moment and we calibrate our theory against it.

3 The Model

To model these issues, we consider a firm-based model of endogenous growth in the spirit of Klette and Kortum (2004). We augment this framework with three ingredients:

1. We assume that entrepreneurs are heterogeneous in their innovation potential.

2. We allow for a margin of occupational choice, whereby workers can either work as production workers or managers.

3. We explicitly introduce contractual frictions in the interaction between firm owners and managers.

The first two items allow us to meaningfully speak about a process of selection. It is the last ingredient that will determine how quickly this process will take place. As with our evidence presented in Figure 6, we will be using the degree of contractual frictions as our source of variation across countries.

More precisely, we think of an economy that is populated by two types of agents: workers and entrepreneurs. Entrepreneurs are endowed with production possibilities ("firms") and have the capacity to grow their firms through innovation. Entrepreneurs come in two types, which differ in their innovation costs: while high types can perform innovation activities and hence generate sustained productivity growth through creative destruction, low types are not capable of starting a thriving business in that they have no talent for innovation. Hence, our model is a heterogeneous firm model, where firms do not differ in their exogenous TFP as in Lucas (1978), but where firms differ in the efficiency of innovation. The process of creative destruction, which is ignited by the

[8] Figure 7 simply plots the raw non-parametric regression without any covariates. In the Appendix we show that the positive correlation between the average product of managerial inputs and firm size is robust to a host of controls.

[9] This is consistent with the findings of Hsieh and Olken (2014), who show that the average product of capital and the average product of labor also seem to be increasing in firm size.

high types, determines how long low types can remain in business. Hence, at the heart of our selection process is the demand for growth of high types.

Entrepreneurs combine their technology with two inputs of production: workers and managerial effort. By increasing the amount of managerial effort, firms can increase the efficiency of their physical production factors. Hence, well-managed firms have high "x-efficiency" in that they combine their technology and their production workers more effectively. While workers are simply hired in a frictionless spot market, the provision of managerial effort is more involved. In particular, managerial services can either be provided by the entrepreneur himself or can be outsourced to a specialized manager. Specialized managers are useful in that they can provide managerial services more efficiently, for example because the owner needs to split his available time between managerial tasks and additional strategic decisions. However, the interaction between entrepreneurs and managers is subject to contractual frictions, which will taint the efficiency with which managers can be employed. This has important dynamic ramifications: because large firms will - endogenously - be harmed more by contractual imperfections, the incentives to grow large are low when contracts are hard to enforce. Hence, the demand for creative destruction will - endogenously - be low and the economy will be sclerotic for two reasons. First, low types, i.e., firms without any growth potential, will survive for a long time conditional on entry. Second, contractual frictions reduce the demand for outside managers, both by reducing managerial demand of firms of a given size and by changing the stationary distribution of firm size toward smaller firms.

For simplicity we assume that both managers and entrepreneurs are short-lived. More precisely entrepreneurs live for one period and then hand over the firm to their offspring, who also live for one period. This is isomorphic to an environment where entrepreneurs are infinitely lived but have a planning horizon of only one period. This is useful for analytical tractability and captures all the economic intuition.

3.1 Preferences and Technology

On the demand side, we model workers as a representative household, with standard preferences

$$U_0 = \int_0^\infty \exp\left(-\rho t\right) \ln C_t dt, \tag{1}$$

where, as usual, $\rho > 0$ is the discount factor. Given the unitary intertemporal elasticity of substitution, the Euler equation along the balanced growth path is simply given by

$$g = r - \rho,$$

where g is the growth rate of the economy and r is the interest rate. Assuming workers to be long-lived is useful in that it determines the equilibrium interest rate. However, it is not essential for the main points of this paper.

The final good, which we take as the numeraire of the economy, is a composite of a continuum of products, which for simplicity takes the Cobb-Douglas form

$$\ln Y_t = \int_0^1 \ln y_{jt} dj, \tag{2}$$

where y_{jt} is the amount of product j produced at time t. Production takes place by heterogeneous firms and uses both production workers and managers. In particular, the production function for good j at time t is given by

$$y_{jf} = q_{jf} m\left(e_f\right) l_{jf}, \tag{3}$$

where q_{jf} is the firm-product specific production technology, $m(e_f)$ denotes the amount of managerial efficiency units employed by firm j and l_{jf} is the number of workers employed for producing intermediate good j. Naturally, $m(e)$, which we will specify below, is strictly increasing. Note that managerial effort is employed at the firm level, so that $m(e_f)$ has no j index. Anticipating our results slightly: With incomplete managerial contracts, it will be hard to elicit the efficient level of managerial effort e_j. Hence, e_j will be derived endogenously from the principal agent relationship between the firm owner and the manager (in case the firm decides to outsource the provision of managerial effort). The distribution of efficiencies $q_{j,t}$ will evolve endogenously through firms' choices of innovation spending and will determine which firm produces which product.[10] As workers are in fixed supply, the labor market clearing condition is given by

$$L = L_t^P + L_t^M, \tag{4}$$

where L_t^P and L_t^M are production and managerial workers respectively.

3.2 Static Equilibrium

Now consider the equilibrium in the product market. At each point in time, each product line j is populated by a set of firms that can produce this good with productivity $\left[q_{jt}^f\right]_f$, where f identifies the firm. We will make sufficient assumptions on $m(.)$, that the most productive firm (which we will sometimes refer to as the (quality) leader) will be the sole producer of product j. Intuitively, while managerial slack can and will be a drag on efficiency, it can never reverse comparative advantage based on physical efficiency q. This assumption will make the structure of the optimal contract between entrepreneurs and managers slightly easier but it is not essential for our results. Additionally we assume that fringe firms (i.e. the followers) can produce the good at a technological disadvantage. Specifically, we assume that there is imperfect diffusion of technology, i.e., if the leader in product j can produce the product with efficiency q_{jt}, the remaining firms can produce it with efficiency $\frac{q_{jt}}{\gamma}$ for some $\gamma > 1$. This assumption allows us to sidestep some issues of mark-up heterogeneity, which we do not think to be of first-order importance to understand differences in the life-cycle of firms across countries.[11]

The Cobb-Douglas structure in (2) implies that the demand for an individual product will have unitary demand elasticity. Hence, the leader will always be forced to engage in limit pricing. Given this assumption, the equilibrium price for product j is given by

$$p_{ij} = \frac{\gamma w_t}{q_{jt}}, \tag{5}$$

as $\frac{\gamma w_t}{q_{jt}}$ are exactly the competitive fringe's marginal costs of producing product j. Equation (2) then implies that the demand for product j is given by

$$y_{jt} = \frac{Y_t}{p_{ij}} = \frac{q_{jt} Y_t}{\gamma w_t}, \tag{6}$$

so that total sales are simply $S_{jt} = p_{jt} y_{jt} = Y_t$, i.e., equalized per product. This, of course, does not imply that the distribution of sales is also equalized across firms; as some firms will (endogenously) have more products than other firms, the distribution of sales is fully driven by the distribution of products. This tight link between firm-level sales and firms' product portfolios is not only

[10] We will be using the terms efficiency and productivity interchangeably when referring to q.

[11] See Peters (2013) for a related model that focuses on heterogeneous mark-ups.

analytically attractive but also conceptually useful in that it clarifies that our model attributes firm dynamics to a single mechanism: why countries differ in the speed at which firms accumulate (and lose) products along their life-cycle.

Similarly, the allocation of labor demand is simply

$$l_{jft} = \frac{y_{jft}}{q_{jft} m\left(e_{ft}\right)} = \frac{Y_t}{m\left(e_{ft}\right) \gamma w_t}, \tag{7}$$

i.e., the allocation of labor across products depends on firms' managerial choices. While all products within a firm have the same number of workers, managerial efficiency is *labor-saving.* Intuitively, an increase in managerial effort *increases* profitability as it increases the firms' sustainable mark-up. To see this, note that equilibrium mark-ups are given by

$$\zeta_{jft} = \frac{p_{jft}}{MC_{jft}} = \frac{\frac{\gamma w_t}{q_{jt}}}{\frac{w_t}{q_{jt} m\left(e_{ft}\right)}} = \gamma m\left(e_{ft}\right), \tag{8}$$

i.e., well-managed firms can keep their competitors at bay, sustain high prices and hence move up on their product demand curve. The resulting profit (before paying the managers) for producer f of variety j is then simply

$$\tilde{\pi}_{jft} = \left[\frac{\gamma w_t}{q_{jt}} - \frac{w_t}{q_{jt} m\left(e_{ft}\right)}\right] \frac{q_{jt} Y_t}{\gamma w_t} = \frac{\gamma m\left(e_{ft}\right) - 1}{m\left(e_{ft}\right) \gamma} Y_t, \tag{9}$$

i.e., profits depend *only* on how well the respective firm can incentivize their managers. In particular, $\tilde{\pi}_{jft}$ is increasing in e_{ft}: better managerial practices increase mark-ups and hence profit per product. Equation (9) contains the main intuition about the interaction between contractual frictions and innovation incentives: As contractual frictions will be detrimental to the provision of managerial effort, firms will be unable to sustain high mark-ups as they grow. The marginal product will therefore be less profitable than the average product and incentives to break into new products will be low.

Substituting (6) into (2) we get that equilibrium wages are given by

$$w_t = \frac{1}{\gamma} Q_t,$$

where Q_t is the Cobb-Douglas composite of individual efficiencies

$$\ln Q_t \equiv \int_0^1 \ln q_{jt} dj.$$

Using (7), we get that $l_{jft} = \frac{1}{Q(t) m\left(e_{ft}\right)} Y_t$, so that total output is given by

$$Y_t = Q_t M_t L_t^P, \tag{10}$$

where

$$M_t = \left[\int m\left(e_{ft}\right)^{-1} df\right]^{-1}. \tag{11}$$

Here, M_t is the endogenous TFP term based on managerial effort. In particular, increases in x-efficiency, i.e., managerial effort, will increase aggregate TFP.[12]

[12]Note that the integral in (11) integrates over *firms* and not products.

3.3 Innovation and Entry

As usual in firm-based models of endogenous growth, growth stems from two margins: entry and innovation by incumbent firms. In order to focus on the process of selection (or lack thereof), we assume that each period there is a measure N of entrepreneurs entering the economy at each point in time. This can be thought of as an exogenous flow of business ideas to outsiders, who enter the economy as new entrepreneurs. Importantly, entrants are heterogeneous and are either of high or low types as discussed above. Formally, upon entry, each new entrant draws a firm type $\theta \in \{\theta_H, \theta_L\}$ from a Bernoulli distribution, where

$$\theta = \begin{cases} \theta^H & \text{with probability } \alpha \\ \theta^L & \text{with probability } 1-\alpha \end{cases}.$$

The type of the firm determines its innovation productivity or growth potential. In particular, each firm is endowed with an innovation technology. If a firm of type θ with n products in its portfolio invests R units of the final good in R&D, it generates a flow rate of innovation of

$$X\left(R;\theta,n,Q\left(t\right)\right) = \theta\left(\frac{R}{Q\left(t\right)}\right)^{\zeta} n^{1-\zeta}. \tag{12}$$

Hence, θ parameterizes the efficiency of innovation resources. For simplicity we assume that $\theta_L = 0$, i.e. low types will never be able to grow and we can focus on the high types' decisions. The other terms in the innovation technology are the usual scaling variables in many models of growth. Because we denote innovation costs in terms of the final good, the scalar $Q\left(t\right)$ is required to keep the model stationary and the presence of n implies that the costs of innovation do not scale in firm size. To see this, note that the cost function of an innovation rate per product $x = \frac{X}{n}$ is given by

$$C\left(x \mid n, Q\left(t\right), \theta\right) = nQ\left(t\right)\left[\frac{x}{\theta}\right]^{\frac{1}{\zeta}}. \tag{13}$$

Each period the new generation of entrepreneurs will try to enter the economy. They are successful in doing so with flow rate z and enter the economy as a single product firm. Unsuccessful entrepreneurs exit the economy. Hence, the total amount of entrants is simply given by

$$\text{Entry} = z \times N,$$

where a fraction α of new entrants are high-types.

After entry decisions have taken place, firms can try to innovate. Letting $V_i\left(n,t\right)$ be the value of having a firm of type i with n products (to be defined below), the value of an incumbent of type i with n products prior to the innovation stage is given by

$$W_i^{INC}\left(n,t\right) = V_i\left(n,t\right) + \max_x \left\{xn\left[V_i\left(n+1,t\right) - V_i\left(n,t\right)\right] - C\left(x \mid n, Q\left(t\right), \theta_i\right)\right\}, \tag{14}$$

where $C\left(x \mid n, Q\left(t\right), \theta\right)$ is given in (13). Hence the profit-maximizing innovation rate is given by

$$\begin{aligned} x^*\left(n,t\right) &= \arg\max_x \left\{x\left[V_i\left(n+1,t\right) - V_i\left(n,t\right)\right] - Q\left(t\right)\left[\frac{x}{\theta}\right]^{\frac{1}{\zeta}}\right\} \\ &= \left[\zeta\Delta_i\left(n,t\right)\right]^{\frac{\zeta}{1-\zeta}} \theta^{\frac{1}{1-\zeta}}, \end{aligned} \tag{15}$$

where $\Delta_i(n,t)$ denotes the marginal return to innovation

$$\Delta_i(n,t) \equiv \frac{V_i(n+1,t) - V_i(n,t)}{Q(t)}. \tag{16}$$

As $x_L(n,t) = 0 < x_H(n,t)$, (14) implies that $W_H^{INC}(n) > W_L^{INC}(n)$.

Equations (16) and (15) are crucial equations in that they link firms' innovation incentives to the *slope* of the value function V_i. Hence, for large firms in India to *not* have high innovation incentives as they grow large, it has to be the case that innovation incentives are declining in size, which in turn requires that V_i be very concave in India but far less so in the US. We will see below that contractual frictions naturally cause concavity in the value function.

3.4 Flow Equations and the Stationary Distribution

To study the aggregate consequences of selection, we need to keep track of the share of product lines belonging to high and low types respectively. Let us denote the share of the product lines that belong to $n-$product high type firms by μ_n^H and the share of the product lines that belong to all low type firms by μ^L.[13] Then

$$\mu^L + \sum_{n=1}^{\infty} \mu_n^H = 1. \tag{17}$$

Firms lose products if they are replaced by either new entrants or successful incumbents. Let us denote the aggregate creative destruction, i.e., the rate at which the producer of a given product is replaced, by τ, where

$$\tau \equiv \underbrace{\sum_{n=1}^{\infty} x_n \mu_n^H}_{\text{Incumbent high types}} + \underbrace{z\alpha N}_{\text{Entry of high types}} + \underbrace{z(1-\alpha)N}_{\text{Entry of low types}} = \sum_{n=1}^{\infty} x_n \mu_n^H + zN. \tag{18}$$

In the steady state, the amount of entry of low types must be equal to the rate at which low types are being replaced. Hence,

$$\mu^L \tau = z(1-\alpha)N, \tag{19}$$

where the LHS denotes the aggregate number of low-type products that are being replaced, and the RHS is the gross number of products that enter the economy as products by low type firms. Similarly, the amount of entry by high types must be equal to the amount of exit of high-type producers. As firms exit whenever they lose their last product, it has to be that

$$\tau \mu_1^H = z\alpha N. \tag{20}$$

In general, the flow equations for the set of high type producers imply that in the steady state

$$\mu_n^H n [\tau + x_n] = \mu_{n-1}^H [n-1] x_{n-1} + \mu_{n+1}^H \tau [n+1]. \tag{21}$$

Here, the LHS of (21) is the number of high type firms that exit state n and the RHS gathers the number of high types that enter state n. These can come from two sources: Either they grow from being an $n-1-$firm to being an $n-$firm or they used to have $n+1$ products but lost one product against another competitor. For given innovation schedules $\{x_n\}$ and entry rate zN, (17)-(21) fully characterize the stationary distribution of the economy.[14] As x_n is only dependent on Δ_n (see (15)),

[13] Recall that in our model, low type firms will always be one-product firms.

[14] To see this, let zN, $\{x_n\}$ and τ be given. From (19) and (20) we can then get μ^L and μ_1^H. Using (21) and (17) we can then solve for $\{x_n^H\}$. Then we still have (18) to solve for τ.

(17)-(21) are also sufficient to solve for the dynamic evolution of the economy given a schedule of *marginal returns* $\{\Delta_n\}_n$. It is precisely this marginal return schedule that we will construct from the incomplete contracts game between owners and managers.

3.5 The Value of the Firm

After innovation outcomes have been realized and observed, firms hire production workers, set prices and decide whether to hire an outside manager. We assume that matching between firms and managers is frictionless and that the market clears in equilibrium. The important aspect of the model is that we introduce an explicit imperfect contract into the theory. While the entrepreneur makes the innovation decision (i.e., solves the problem (15)), the day-to-day affairs can be run by outside managerial personnel. The contractual incompleteness arises in that managerial effort is not directly contractible. In particular, we follow Grossman and Hart (1986) and Acemoglu et al. (2007) to assume that the manager and the entrepreneur engage in Nash Bargaining about the joint surplus ex-post. As an imperfect substitute for a contract to limit the firms' hold-up, we assume that the firm can monitor the manager and thereby ensure a fraction of the managerial effort to be exerted ((Bloom et al., 2009, 2010)). This monitoring technology allows the owner to limit the exposure of managerial hold-up ex-post, but it also reduces managerial incentives ex-ante. As will be clear in the theory, intense monitoring is as if firms were granting little authority to the manager. We will see that in equilibrium firms will be heterogeneous in their demand for managerial monitoring. Moreover, it is precisely the pattern of optimal monitoring that will determine the marginal return schedule $\{\Delta_n\}_n$. Clearly, not all firms hire managers from outside. This is particularly true in India, where the vast majority of small firms are family firms. To capture this important aspect in our theory, entrepreneurs do not have to delegate authority to outside managers. In contrast, they can also decide to manage their own firm. The advantage of doing so is that contractual frictions do not apply and that the firm can save on managerial wages. The downside is similar to Caselli and Gennaioli (2012): owners might not be the best managers.

We assume that managerial effort enters the production function according to

$$m(e) = \frac{1}{\gamma - (\gamma - 1) e^{\sigma}}.$$

This functional form is convenient, because it implies (see (9)) that the flow profits of a firm (before paying for any managers in case the firm decides to hire some) are given by

$$\pi(n, t) = \frac{\gamma - 1}{\gamma} e^{\sigma} Y(t) n,$$

as mark-ups equal (see (8))

$$\zeta_{ft} = \frac{p_{jft}}{MC_{jft}} = \frac{\gamma}{\gamma - (\gamma - 1) e^{\sigma}}, \tag{22}$$

and hence are increasing in e. The managerial effort bundle in turn is an aggregate of many managerial *tasks*. In particular, we assume that a unit continuum of tasks to be performed and that

$$e = exp\left(\int_0^1 ln\left(e(i)\right) di\right),$$

where $e(i)$ denotes managerial effort for task i. This structure is convenient once we want to parameterize the quality of the contractual system (see below).

Given this structure, the firms now have the choice to "buy" e from managers or to provide them on their own. The benefit of hiring managers is that specialized managers can provide managerial efficiency more effectually. However, hiring managers is also costly. Not only do managers have to get remunerated for their services and their opportunity costs (as they could have been entrepreneurs themselves) but the interaction between owners and outside managers is plagued by contractual frictions.

3.5.1 The case of no managerial delegation

Consider first a firm that decides to not hire a manager. Provision of effort is costly. In particular, the owner suffers utility costs of

$$C\left(\left[e\left(i\right)\right]_i, Q\left(t\right)\right) = v_H n Q\left(t\right)\left[\int_0^1 e\left(i\right) di\right], \tag{23}$$

where ν_H is a cost-shifter. The value of the firm is hence given by

$$V^{NM}\left(n\right) = \max_{[e(i)]}\left\{\frac{\gamma-1}{\gamma} e^{\sigma} Y\left(t\right) n - v_H n Q\left(t\right)\left[\int_0^1 e\left(i\right) di\right]\right\}.$$

The solution to this problem is given by

$$V^{NM}\left(n\right) = \left(1-\sigma\right)\frac{\gamma-1}{\gamma}\left(e_{NM}\right)^{\sigma} Y\left(t\right) n, \tag{24}$$

where

$$e_{NM} = \left(\frac{\gamma-1}{\gamma}\frac{\sigma}{v_H}\frac{Y_t}{Q_t}\right)^{\frac{1}{1-\sigma}}, \tag{25}$$

and $\frac{Y_t}{Q_t}$ is constant in a stationary equilibrium. In particular, we can also express V^{NM} as

$$V^{NM}\left(n\right) = \left(1-\sigma\right)\pi^{NM} Y\left(t\right) n, \tag{26}$$

where

$$\pi^{NM} \equiv \frac{\gamma-1}{\gamma}\left(\frac{\gamma-1}{\gamma}\frac{\sigma}{v_H}\frac{Y_t}{Q_t}\right)^{\frac{\sigma}{1-\sigma}} \tag{27}$$

is a constant.

Importantly, (26) and(16) imply that

$$\Delta^{NM}\left(n,t\right) = \Delta^{NM} = \frac{\left(1-\sigma\right)\pi^{NM} Y\left(t\right)}{Q\left(t\right)} = \left(1-\sigma\right)\pi^{NM} M_t L_t^P. \tag{28}$$

As both M and L^P will be constant in a stationary equilibrium, (28) implies that the marginal returns to innovation will be constant for firms of different sizes in case they decide to *not* hire an outside manager.

3.5.2 The case of managerial delegation

Now suppose the firm was to hire an outside manager. We assume that firms are matched with managers and make take-it-or-leave-it offers. As the managers' outside option is to enter the economy as a production worker, the contract has to give the manager a surplus of (at least) w_t. Taking this outside option as given, the firm and the manager enter a contracting game, which is similar to Acemoglu et al. (2007). The ease with which contracts can be written depends on the *contractual environment,* which is defined to be the subset of tasks that are contractible. In particular, we assume that of the unit mass of tasks, only the measure $[0, \mu]$ can directly be contracted for, in that the required managerial effort levels $e(i)$ are enforceable in court. We take μ as a country characteristic, with its empirical analog being the rule of law index, which we used in our empirical section above.

To model the game between owners and managers, we follow the standard incomplete contract literature that says the provision of managerial effort requires an ex-ante investment and that the manager and the entrepreneur engage in Nash Bargaining about the joint surplus ex-post. As an imperfect substitute for a contract to limit the firms' hold-up, we assume that the firm can monitor the manager and thereby ensure a fraction of the managerial effort to be exerted. This monitoring technology (which we think of as an endogenous limit to managerial authority, as in the work of Nick Bloom and John Van Reenen) allows the owner to limit the exposure of managerial hold-up ex-post, but it also reduces managerial incentives ex-ante. The precise timeline of the game is as follows:

1. The entrepreneur is matched to a manager, who has an outside option of w_t. The entrepreneur offers a contract that specifies an ex-ante transfer from the owner to the manager $\tau \geq 0$, managerial efforts in contractible tasks $[e_C(i)]_{i=0}^{\mu}$ and a degree of monitoring $\delta \in [0,1]$. The contract will not be able to enforce effort in non-contractible tasks $[e_{NC}(i)]_{i=\mu}^{1}$.

2. Given the contract, the manager choses the effort levels of *all* tasks, i.e., $[e_C(i)]_{i=0}^{\mu}$ and $[\hat{e}_{NC}(i)]_{i=\mu}^{1}$. Doing so is subject to utility costs

$$C^M\left([e(i)]_i, Q(t)\right) = v_L n Q(t)\left[\int_0^1 e(i)\, di\right], \tag{29}$$

   where $\nu_L < \nu_H$, i.e., in contrast to owners, managers are more productive in providing managerial tasks. This reflects the efficiency gains of delegation and division of labor.

3. The firm hires production workers and is committed to paying their wage $w(t)$.

4. At the end of the period, the manager can threaten to withhold his services in the non-contractible activities $[\hat{e}_{NC}(i)]_{i=\mu}^{1}$, i.e. he can threaten to set $\tilde{e}(i) = \delta \hat{e}(i)$ instead of $\hat{e}(i)$.[15] Hence, through monitoring, the firm can reduce its exposure to managerial non-performance. In particular, the manager demands a payment P in return for actually performing an effort

[15] A more detailed microfoundation of the game is as follows: in stage 4, when the manager decides on his effort, we can think of him as learning the details of the firm (firm-specific knowledge). Let $[\hat{e}(i)]_{i=\mu}^{1}$ be the level of learning. The costs of learning are given by (29). Given a level of learning $\hat{e}(i)$, the cost of *providing* effort is then given by

$$\Gamma(e, \hat{e}) = \begin{cases} 0 & \text{if } e \leq \hat{e} \\ \infty & \text{if } e > \hat{e} \end{cases}.$$

Hence, in stage 4, the manager essentially invests in the capability of providing effort, and once these costs are sunk, she can provide these at zero marginal costs. She can, however, threaten to not show up to work.

level of $[\hat{e}_{NC}(i)]_{i=\mu}^{1}$ and not to only set $[\delta\hat{e}_{NC}(i)]_{i=\mu}^{1}$. P is decided by Nash Bargaining between the firm and the manager. Note that the ex-ante transfer τ is already paid, i.e. is not subject to the bargaining. As there are gains from trade, they will bargain to the efficient ex-post outcome and the manager will put in $\hat{e}$ units of effort.

5. Production takes place and payments are settled.

While our interpretation is different, our game is a standard incomplete contract game, where a "supplier" (the manager) has to do a relationship-specific investment but can threaten to withhold his services in the process of joint production. Note that the firm *also* engages in a relationship-specific investment - the innovation. However, because the parties can transfer utility (via the ex-ante payment τ) *after* the innovation is made but *before* the manager decides on his effort level, there is not necessarily an inefficiency.

Given this structure of the game, we can determine the value of the firm under managerial delegation, $V^M(n)$. As usual we solve the game with backward induction. We first state a useful result, namely, the structure of the managerial payment P.

Lemma 1 *Let α be the bargaining share of the manager. The ex-post payoff to the manager in the bargaining game is given by*

$$P = \alpha\left(1-\delta^{\sigma(1-\mu)}\right)\frac{\gamma-1}{\gamma}e^{\sigma}Y(t)\,n = \alpha\left(1-\delta^{\sigma(1-\mu)}\right)\pi\left([e_C]_0^{\mu},[e_{NC}]_{\mu}^{1},n;Y(t)\right), \tag{30}$$

where

$$e = exp\left(\int_0^{\mu} ln\left(e_C(i)\right)di + \int_{\mu}^{1} ln\left(e_{NC}(i)\right)di\right).$$

Proof. See Section 6.4 in the Appendix. ■

Hence, ex-post the manager receives a constant share of profits. This share, however, is partly under the control of the firm through the exertion of monitoring effort δ. In particular, through its choice of δ, the firm can govern the degree of managerial *authority*

$$\vartheta \equiv \alpha\left(1-\delta^{\sigma(1-\mu)}\right), \tag{31}$$

and we will have the firm directly choose ϑ. We will see that the distribution of endogenous authority across firm ϑ will be a crucial object in the analysis. By choosing ϑ, the firm experiences the well-known trade-off of assigning property rights: monitoring the manager intensely will reduce managerial authority ϑ and hence the degree of hold-up the firm faces ex-post. However, it will also reduce the manager's allocation of effort in non-contractual tasks. In particular, given his payoff P and the cost function C^M (see (29)), the optimal condition for the manager's effort in non-contractual tasks is given by

$$\vartheta\frac{\gamma-1}{\gamma}\sigma e^{\sigma}\frac{1}{e^{NC}(i)}Y(t)\,n = v_L n Q(t). \tag{32}$$

As all tasks are symmetric, we have $e^{NC}(j) = e^{NC}$ for $j \in [\mu,1]$. Similarly, the optimal contract will specify symmetric effort levels for the contractual activity, i.e. $e_C(i) = e_C$ for $i \in [0,\mu]$. Hence, total managerial effort is given by

$$e = exp\left(\int_0^{\mu} ln\left(e_C(i)\right)di + \int_{\mu}^{1} ln\left(e_{NC}(i)\right)di\right) = e_C^{\mu}e_{NC}^{1-\mu},$$

which is a simple Cobb-Douglas "production function", where the Cobb-Douglas shares are determined by the contractual environment. From (32) we hence get the optimal amount of effort in non-contractual tasks as

$$e_{NC} = \left[\vartheta \frac{\sigma}{v_L} \frac{\gamma - 1}{\gamma} \frac{Y(t)}{Q(t)} e_C^{\mu\sigma}\right]^{\frac{1}{1-(1-\mu)\sigma}}. \tag{33}$$

Equation (33) clearly shows the two instruments that the firm has to govern managerial incentives in non-contractual tasks. First, it can increase the manager's non-contractual effort by giving the manager a large degree of authority ϑ. While this increases the provision of effort, it also reduces the share of profits the firm eventually keeps. Second, the firm can exploit the fact that contractual and non-contractual efforts are complements, i.e., e_{NC} is increasing in e_C. Intuitively, by forcing the managers to work particularly hard at those tasks for which contracts can be written, the firm increases managerial incentives in other tasks. While such behavior will emerge in countries with bad institutions, it will, of course, be inefficient as the marginal return between contractual and non-contractual tasks will not be equalized.

With Lemma 1 at hand we can now formally define the value of the firm. As the firm makes a take-it-or-leave it offer to the manager taking his outside opportunity as given, the value of hiring a manager is implicitly defined by the optimal contracting problem

$$V^M(n,t) \equiv \max_{\tau,\vartheta,[e^C(i)]_0^\mu} (1-\vartheta)\,\pi\left([e_C]_0^\mu, [e_{NC}]_\mu^1, n; Y(t)\right) - \tau \tag{34}$$

subject to

$$w \leq \vartheta\pi\left([e_C]_0^\mu, [e_{NC}]_\mu^1, n; Y(t)\right) - v_L n Q(t)\left(\left[\int_0^\mu e_C(i)\,di\right] + \left[\int_\mu^1 e_{NC}(i)\,di\right]\right) + \tau \tag{35}$$

$$\tau \geq 0 \tag{36}$$

$$\vartheta \leq \alpha \tag{37}$$

$$e_{NC}(i) = \arg\max_{e_{NC}(i)} \left\{\vartheta\pi(e_C, e_{NC}, n) - v_L n Q(t)\left[\int_\mu^1 e_{NC}(i)\,di\right]\right\}, \tag{38}$$

where

$$\pi\left([e_C]_0^\mu, [e_{NC}]_\mu^1, n; Y(t)\right) = \frac{\gamma-1}{\gamma} exp\left(\int_0^\mu ln\left(e_C(i)\right)di + \int_\mu^1 ln\left(e_{NC}(i)\right)di\right)^\sigma Y(t)\,n.$$

Hence, the firm has three control variables to govern the relationship with its manager: it assigns effort in contractual tasks (e_C), it chooses the degree of authority (ϑ) and it distributes surplus via the ex-ante payment (τ). When doing so, however, it is subject to three constraints. First, it has to satisfy the participation constraint of the manager (35). Second, we assume that managers cannot *pay* firm owners up-front to work for them, i.e., managers do not have pockets deep enough to allow them to simply buy the firm. We will see that (36) is an important constraint and we will come back to it in Section 4.4 below. Finally, (38) is the managers' incentive constraint for non-contractual effort, the solution of which is simply (33).[16]

[16]The restriction on managerial authority ϑ (see (31)) simply reflects the fact that the firm can reduce managerial authority only by monitoring. For our main results we will focus on the case of $\alpha = 1$, which is analytically attractive. For that case, (31) will never be binding. The general case of $\alpha < 1$ is contained in the Appendix.

Before characterizing the optimal contract, note that the participation constraint (35) will always be binding because of the presence of some contractual tasks. As the marginal product of contractual tasks is positive, the firm will always simply have the manager work more in such activities until the manager's participation constraint binds.

To characterize the optimal contract under *imperfect* contractual enforcement, consider first Proposition 1, which contains the characterization of the solution to (34) for the case of perfect contracts.

Proposition 1 *Consider the setup above and suppose $\mu = 1$, i.e., contracts can be perfectly enforced. Then:*

1. *Managerial effort is given by*

$$e^{PC} = \left(\frac{\sigma}{\nu_L}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}\right)^{\frac{1}{1-\sigma}} = \left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}} e^{NM}, \tag{39}$$

   where e^{NM} is given in (25).

2. *The value of the firm $V^M(n,t;\mu)$ is given by*

$$\begin{aligned} V^M(n,t;1) &= (1-\sigma)\frac{\gamma-1}{\gamma}\left(e^{PC}\right)^{\sigma} Y(t)\, n - w(t) \\ &= \left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}} V^{NM}(n,t) - w(t), \end{aligned} \tag{40}$$

   where V^{NM} is given in (26). Hence, innovation incentives are governed by

$$\Delta^{PC}(n,t) = \Delta^{PC} = \left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}} \Delta^{NM}, \tag{41}$$

   where Δ^{NM} is given in (28).

Proof. See the Appendix. ■

Proposition 1 shows that the solution under perfect contracts has a very similar structure to the case of non-delegation. Firms with specialized managerial personnel will employ more managerial effort (see (39)), which reflects the comparative advantage of outside managers to provide such services. As a result, the value function has a steeper slope (see (40)), which increases the innovation incentives of firms with outside managers relative to their non-delegating counterparts. Hence, as long as contracts are perfect, this economy is one where firms face a "fixed-costs-variable-costs" trade-off: while hiring an outside manager is subject to fixed costs because he has to be remunerated for his opportunity costs $w(t)$, the efficiency gains from the provision of effort increase firms' mark-ups (see (22)) and hence their variable profits. As in the canonical model of Klette and Kortum (2004), however, innovation incentives are independent of firm-size.

The interesting case in our model is, of course, the one where contracts are *not* perfect. If that is the case, owners have to elicit managerial effort through the distribution of authority ϑ and their assignment of contractual effort. Firms' optimal policies and the implications for firm valuations are contained in the following Proposition.

Proposition 2 *Consider the set-up above and let $\alpha = 1$. Let $\vartheta(n,\mu)$ be the endogenous allocation of authority. Then:*

1. *Managerial effort levels* (e_C, e_{NC}) *and the value function* V^M *are equal to their perfect contracts benchmark if and only if* $\vartheta(n,\mu) = 1$.

2. *Suppose that authority is restricted, i.e.* $\vartheta(n,\mu) < 1$. *Then:*

   (a) *Effort across tasks is misallocated in that there is over-provision of contractual effort and under-provision of non-contractual effort, i.e.*

$$e_{NC} \leq e_{PC} \leq e_C \text{ and } \frac{\partial e_{NC}}{\partial \vartheta} > 0 > \frac{\partial e_C}{\partial \vartheta}. \tag{42}$$

   (b) *The value of the firm is*

$$V^M(n,t;\mu) = h(\vartheta,\mu)\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}} V^{NM}(n,t) - w(t), \tag{43}$$

   where $h(\vartheta,\mu) < h(\vartheta,1) = h(1,\mu) = 1$ *and* $\frac{\partial}{\partial\vartheta}h(\vartheta,\mu) > 1$. *In particular*

$$h(\vartheta,\mu) = \left(1 - \sigma\vartheta\left(1 + \frac{\mu(1-\vartheta)}{\vartheta - (1-\mu)\sigma}\right)\right)\left(\left(\frac{1-\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}}. \tag{44}$$

   (c) *Innovation incentives are given by*

$$\Delta^M(n,t;\mu) = \Delta^{PC} \times \left[h(\vartheta(n+1,\mu),\mu)(n+1) - h(\vartheta(n,\mu),\mu)\,n\right]. \tag{45}$$

Proof. See the Appendix. ■

Proposition 2 contains two sets of important results. First, imperfect contracts do not necessarily translate into inefficiencies. As shown in the first part of the proposition, contractual frictions *only* matter in so far as they reduce managerial authority below unity. More precisely, as long as the firm provides full authority to the manager, $\vartheta = 1$, the allocations replicate the perfect contract allocations irrespective of μ. The reason is the usual property rights intuition: Full authority makes the manager the residual claimant to the firm. As the owners' input into joint production is realized before bargaining takes place, the intuition from Grossman and Hart (1986) suggests assigning property rights to the manager. Contractual frictions, therefore, matter *only* in so as far as firms are unwilling to delegate authority to their managerial personnel. The second part of Proposition 2 then characterizes the consequences of limits to authority in our theory: incomplete contracts introduce distortions into the provision of managerial effort. As seen from (42), effort is inefficiently provided in *both* types of tasks. While effort in contractual activities is too high, there is too little effort in the non-contractual part of managerial activities. The reason for this result are precisely the complementarities discussed above (see (33)): as limits to authority *reduce* the managers' incentives to invest in non-contractual effort, the owner optimally over-assigns contractual effort to incentivize the manager. Equation (43) then shows the consequences of this intra-firm distortion: Limits to authority lower the owners' valuation relative to the case of perfect contracts. Finally, (45) shows when and why innovation incentives are *not* constant. Since the allocation of authority determines the firms value function, it will be *changes* in authority that will affect innovation incentives of firms' of different sizes. Hence, contractual frictions shape the process of firm dynamics by shaping the way different firms allocate managerial authority. How firms of different sizes allocate authority is the content of the following Proposition.

Proposition 3 *Consider the set-up above and define a critical level of firm size* n^* *as*

$$n^* = \frac{1}{(1-\sigma)\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}} \pi^{NM} \frac{Y(t)}{w(t)}}, \tag{46}$$

where π^{NM} *is given in (27) and* $\frac{Y(t)}{w(t)}$ *is constant in the steady state. The optimal degree of authority* $\vartheta(n,\mu)$ *satisfies*

$$\vartheta(n,\mu) = \begin{cases} 1 & \text{if } n \leq n^* \\ \vartheta^C(n,\mu) & \text{if } n > n^* \end{cases},$$

where

1. $\vartheta^C(n^*,\mu) = 1$, *i.e.,* $\vartheta(n,\mu)$ *is continuous,*
2. $\frac{\partial \vartheta^C(n,\mu)}{\partial n} < 0$, *i.e., bigger firms grant less authority,*
3. $\frac{\partial \vartheta^C(n,\mu)}{\partial \mu} > 0$, *i.e., better contracts induce firms to grant more authority,*
4. $\lim_{n\to\infty} \vartheta(n,\mu) = \sigma$, *i.e., the limit of managerial authority does not depend on the legal system.*

Proof. *In the Appendix we show that* $\vartheta^C(n,\mu)$ *is implicitly defined by*

$$\frac{n^*}{n} = \frac{\vartheta - \sigma}{1-\sigma}\left[\left(\frac{1-(1-\mu)\sigma}{\vartheta^C(n,\mu)-(1-\mu)\sigma}\right)^{1-\sigma(1-\mu)} \vartheta^C(n,\mu)\right]^{\frac{1}{1-\sigma}}. \tag{47}$$

The properties of ϑ^C *follow from (47).* ■

Proposition 2 showed that firms achieve "x-efficiency" only when they grant full authority to their managers. Proposition 3 then characterizes *which* firms are optimally giving full decision power to their managerial personnel. Not only is full efficiency not achieved by all firms in the economy, but more important, in particular, large firms have higher incentives to distort managerial incentives. Moreover, limits to authority will be more severe in environments where contractual frictions are large. A summary of Proposition 3 is contained in Figure 8 below. The first salient feature of the optimal allocation of authority is that full authority is granted in small firms (with $n < n^*$). The intuition is as follows: Allocational efficiency (within the firm) requires that $\vartheta = 1$. While this maximizes production efficiency, it also implies that the entirety of firms' profits will be allocated to the manager once the bargaining stage is reached. The reason why firms might still be willing to accept such contracts is, of course, the possibility of reducing the ex-ante payments τ, i.e., small firms essentially solve the contractual friction by making the manager the residual claimant on their profits.[17]

Such transfers, however, are limited by managerial liquidity constraints (see (36)). Since large firms will need to set *higher* ex-ante transfers (because managers will earn higher rents through bargaining ex-post), managerial liquidity constraints will eventually become binding. The critical size of the firm when such liquidity constraints are binding, i.e., when the manager would have

[17]Note that firms with $n < n^*$ might not be willing to even sign a contract with a manager, i.e., they might prefer to perform the required managerial services by themselves. For our baseline case of $\tau \geq 0$, this will be the case (see below). However, in one of our extensions we will consider the general case $\tau \geq -\chi Y(t)$, where this is not necessarily true.

to *pay* to work for the firm, is therefore precisely n^*. Note that this cutoff is increasing in the manager's outside option $\left(\frac{w}{Y}\right)$. The reason is that better outside options ensure that managers require relatively larger payments to even participate in the contract. Note also that liquidity constraints will become tighter the more profits there are to be earned (π^{NM} large and ν_L low) as it requires firms to extract even higher payments ex-ante.

Once liquidity constraints are binding, firms are unable to limit managerial hold-up through ex-ante transfers. Hence, they have to rely on the other two instruments. Either they can require managers to work inefficiently long hours at contractual activities, or they can limit managerial authority, reducing managers' exposure to ex-post hold-up but at the same time reducing their non-contractual incentives. Proposition 3 and the optimal contractual effort e_C (see (42)) show that optimal behavior implies that both margins are distorted. Hence, larger firms are particularly hurt by imperfect contracts as agency problems become more severe. From a dynamic perspective, this implies that contractual problems will *endogenously* reduce innovation incentives because firms cannot seamlessly expand: the returns from growing large in an economy with contractual frictions decline as managerial efficiency deteriorates more and more.

A second implication of Proposition 3 is that better contracts will *increase* managerial authority. In terms of Figure 8, the authority schedule shifts up. This is not obvious. As only non-contractual activities benefit from more authority one could have expected *more* authority to be granted in environments where such authority is more valuable. However, the opposite is the case. The reason for this result is precisely the distortion of contractual effort, whereby an excessive usage of those tasks is used to incentivize non-contractual effort. If μ is large, this "overproduction" is costly and the firm has to remunerate the manager for putting effort into low-marginal-product activities. Hence, the firm shifts from incentivizing the managers with contractual effort to offering incentive schemes that rely on authority.

The implications of such optimal delegation behavior for firms' payoff are contained in Figure 9. We depict the value function as a function of firm size for different levels of the contractual environment. As shown in Proposition 2, the case of perfect contracts corresponds to a linear value function and constant innovation incentives. As the contractual environment deteriorates, managerial authority declines and with it production efficiency. Hence, the value function becomes *concave* as larger firms will be especially affected by contractual frictions. This resonates with the empirical findings of Bloom et al. (2010) and Bloom and Van Reenen (2010). Note also that all value functions lie on top of each other for sufficiently small firms ($n < n^*$): the informal allocation of managerial authority is a good substitute for formal contracts as long as firms are small.

3.6 Innovation Incentives

To determine firms' final innovation incentives we of course have to take into account their binary organizational choice to either hire a manager or provide managerial services themselves. As there are no dynamic ramifications in switching organizational design, this is a simple static trade-off. Hence,

$$V(n,t;\mu) = \max\left\{V^{NM}(n,t), V^{M}(n,t)\right\},$$

where V^{NM} and V^{M} are given in (26) and (43) respectively. Using these expressions we get that a firm hires an external manager whenever

$$V^{M}(n,t;\mu) - V^{NM}(n,t) = \left[h\left(\vartheta(n,\mu),\mu\right)\left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}} - 1\right] V^{NM}(n,t) - w(t) > 0, \quad (48)$$

where h is given in (44). Equation (48) shows concisely the three forces that determine the pattern of organizational form. The last term $w(t)$ is the *opportunity cost* term. Since managers have to be remunerated for their time but owners can perform managerial duties "while owning the firm", employing a manager has fixed costs. The firm's term $h(\vartheta(n,\mu),\mu)\left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}}$ combines two counteracting forces. The first component, $h(\vartheta(n,\mu),\mu)$, is akin to an *imperfect contract tax* as firms will endogenously distort managerial incentives and firm efficiency. As shown in Propositions (2) and (3), large firms will do so particularly strongly so that this tax is size-dependent and hence h is decreasing in firm size. The second term, $\left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}}$, is the *specialization benefit*. Since owners do not have time to specialize in their managerial tasks, they can provide them less efficiently. It is the tradeoff between these two forces and the fixed opportunity costs that determine firms' organizational choice. In particular, imperfect contracts can stand in the way of an efficient division of labor by making the interaction between owners and managers so inefficient that the technological gains from specialization are dominated.

As $h(.)$ is increasing and concave in n, (48) shows that there are three patterns of organizational choice that can prevail in equilibrium:

1. No firm hires a manager,
2. There is a cut-off n^M such that all firms with $n > n^M$ hire managers,
3. There are two cut-offs n_L^M and n_H^M such that all firms with $n_L^M < n < n_H^M$ hire managers.

We consider this last case as somewhat pathological since it implies that optimal authority depreciates so quickly in firm size that the *biggest* firms are again better off not hiring any managers. Hence, we are going to impose Assumption 1, which ensures that this is not the case.

Assumption 1 *Suppose that* $\left(\sigma,\mu,\frac{\nu_H}{\nu_L}\right)$ *are such that*

$$\left(\left(\frac{1-(1-\mu)\sigma}{\mu}\right)^{\mu}\sigma^{1-\mu}\right)\left(\frac{v_H}{v_L}\right)>1.$$

As $\vartheta(n,\mu)\to\sigma$, Assumption 1 implies that $\frac{h(\vartheta(n,\mu),\mu)}{1-\sigma}\left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}}>1$. Hence, the marginal product has a higher return for firms with managerial delegation. Finally we are going to assume that we are in the interesting case where $\frac{v_H}{v_L}$ is sufficiently high so that some firms find it worthwhile to hire an outside manager.

The final pattern of organizational choice is given in Figure 10 below. We depict two managerial value functions (under different contractual environments) and the value of the self-employed firm, which is linear and independent of μ. Since better contracts increase the value of delegation, the value function with managerial decentralization shifts to the lefts as μ increases. Hence, the marginal firm with managerial delegation will be smaller and - holding the firm size distribution fixed - the share of firms that opt to delegate authority will be larger.

Note that - according to Figure 10 - we have $n^* < n_M^H$, i.e., the critical level of firm size to hire outside managers exceeds the one where the liquidity constraint is binding. This does not depend on parameters but is a general result. According to Proposition 3, we have that $\vartheta = 1$ for all $n < n^*$. Hence,

$$V^M(n,t;\mu) = \left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}}V^{NM}(n,t)-w(t)=\left[\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1=\sigma}}(n-n^*)\right]V^{NM}(n,t)<0<V^{NM}(n,t).$$

The reason is intuitive: By construction of n^*, firms with $n < n^*$ will be run efficiently in that they will chose $\vartheta = 1$. Then, however, all the surplus will go to the manager ex-post. If ex-ante payments are ruled out, firms will not be able to appropriate any of these returns and will have negative payoffs. Hence, such firms will clearly be better off running the firm on their own.

In this paper we are, of course, mostly interested in the dynamic ramifications of contractual frictions. The crucial object for innovation incentives is, of course, the slope of the value function (see (16)). The implications of changes in the contractual environment for firms' incentives to grow are contained in Figure 11 below. Consider first the solid line, which represents the slope of the value function in an environment plagued by contractual frictions ($\Delta(n;\mu_L)$). The marginal firm hiring a manager has n_L^M products. Until that point, the firm is managed by its owner and innovation incentives are both constant and low. This follows from (16) and (26), which imply that

$$\Delta^{NM}(n,t) = (1-\sigma)\frac{\gamma-1}{\gamma}\left(\frac{\sigma}{\nu_L}\frac{\gamma-1}{\gamma}\right)^{\frac{\sigma}{1-\sigma}}\left(\frac{Y(t)}{Q(t)}\right)^{\frac{1}{1-\sigma}} \propto \left(\frac{1}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}. \tag{49}$$

If agents *owning* firms are relatively bad in *managing* firms, ν_L will be large and both profit margins and innovation incentives will be low. At n_L^M the firm reaches the critical size for bringing an outside manager into the firm. Through the lens of this model, such managerial upscaling is akin to the adoption of a technology: the firm incurs some fixed costs but it benefits from higher returns on the margin. Hence, innovation incentives will initially be high around the cut-off. However, as the firm grows, contractual frictions become more and more severe, and through limited managerial authority, the firm is less and less able to reap the benefits of managerial specialization. This concavity of the value function (see Figure 10) implies that marginal returns are declining in size. However, Assumption 1 ensures that such marginal returns are bounded from below by (49).

Now suppose that contracts improve. This will shift both the marginal return function and reduce the cutoff of "entering" firms from n_L^M to n_H^M. Such a change is depicted in Figure 11 as the dotted line ($\Delta(n;\mu_H)$). Intuitively, because better contracts enable firms to employ their managers more efficiently, innovation incentives increase holding firm size constant. This mechanism explains the differences in the life-cycle between India and the US: Indian firms will have few incentives to grow, as imperfect contracts will depress the innovation incentives of large firms. Note the importance of the size dependence: small firms will *not* be affected by contractual frictions in either country as they do not delegate decision power to outside managers anyway. Hence, the drag of contractual frictions will be especially severe for large firms so that contractual frictions endogenously act like "size-dependent" policies (Guner et al., 2008). Dynamically, firms will, of course, anticipate that they will run into such decreasing returns. Hence, in equilibrium only a few firms will grow large in India. Finally, consider the perfect contracts benchmark, which is also depicted in Figure 11. As argued above (see (41)), with perfect contracts, the size dependence of the innovation incentives disappears since the value function becomes linear. The adoption cut-off will be reduced to n_M^{PC} and innovation incentives going forward will be constant, as in the standard model of Klette and Kortum (2004).

Conceptually, we think of the two schedules in Figure 11 as representing India and the US: While firms in the US have high innovation and growth incentives and hence expand, firms in India anticipate that they will not be able to run large firms efficiently as the legal system makes it hard to use managers efficiently, i.e., without any distortionary monitoring. Hence, firms in India have fewer incentives to grow. It is this lack of selection, however, that keeps the inefficient low types in the market. In the next section we will study the quantitative bite of this mechanism in a calibrated version of the model.

With Propositions 2 and 3 at hand, we can now formally define the equilibrium, which we will be taking to the data.

Definition 1 *Consider the economy above. A stationary equilibrium is a set of prices* $\left(r, w, [p_f]_f\right)$, *a set of allocations* $\left([l_f, y_f, m_f]_f\right)$, *a set of contracts* $[C_f]_f$, *managerial effort levels* $[e_f]_f$ *and innovation choices* $[x_f]_f$ *and a firm size distribution* G *such that:*

1. *Firm* f *chooses prices* p_f, *employment* l_f, *outside managers* m_f, *innovation efforts* x_f, *contracts* C_f *and effort levels* e_f *to maximize profits.*
2. *Effort levels chosen by outside managers are consistent with the offered contract* C_f.
3. *The firm size distribution* G *is consistent with firm' innovation choices* $[x_f]_f$ *and the entry rate* Nz.
4. *The labor market clears, i.e.,*
$$L = \int l_f dG + \int m_f dG$$
5. *Consumers maximize utility.*

Our discussion above already characterizes most of these objects. The static allocations (p_f, l_f, y_f) follow directly from the static optimality conditions. Proposition 3 then fully characterizes the firms' value function V^M, i.e. the innovation schedule and managerial demands (x_f, m_f) given the wage $w_t = \frac{1}{\gamma} Q_t$ and aggregate output Y_t. After solving for the stationary firm size distribution G, we can then use the labor market clearing condition and the definition of aggregate output to determine the equilibrium.

The deep structural parameters for our economy are the contractual system μ, the share of innovative firms α, the rate of entry z, the efficiency of the innovation technology θ and the outside manager's liquidity constraint $\tau \geq -\chi Y(t)$, which we set to 0 in our benchmark analysis. For our benchmark quantitative comparison, we will allow only μ and α to be country-specific. This will provide the discipline to ask both how much of the US-India difference in the life-cycle is exogenous selection (via α) and how much is endogenous selection (via μ) and what share is accounted for by the endogenous part. We will then consider the remaining three margins as separate extensions.

4 Quantitative Exercise

We now take the basic model to the data. Our quantitative aim is twofold. First, we want to show that the model is able to match the basic facts we set out to explain. Second, we would like to assess the quantitative importance of the contractual frictions between managers and firms in understanding the difference in firm dynamics between India and the US.

4.1 Data

We are using two major sources of data about Indian manufacturing establishments. The first source is the Annual Survey of Industries (ASI) and the second is the National Sample Survey (NSS). The ASI is an annual survey of manufacturing enterprises. It covers all plants employing ten or more workers using electric power and employing twenty or more workers without electric power. For our analysis we use only the cross-sectional data in 1995 to make it comparable to our sample of the

NSS. For an economy like India, the ASI covers only a tiny fraction of producers, as most plants employ far fewer than twenty employees. To overcome this oversampling of large producers in the ASI, we complement the ASI data with data from the NSS. The National Sample Survey is a survey covering different aspects of socio-economic life in India. Every five years, however, Schedule 2.2 of the NSS surveys a random sample of the population of manufacturing establishments without the minimum size requirement of the ASI. While these producers are (by construction) very small, they still account for roughly 30% of aggregate output in the manufacturing sector. We use the NSS data for the year 1994/95 and merge it with the ASI using the sampling weights provided in the data. For a more detailed description and some descriptive statics, we refer to Hsieh and Olken (2014). In terms of the data we use, we mostly focus on the employment side. In particular, we draw on the information on age and employment to study the cross-sectional age-size relationship. Additionally, we use the information on managerial personnel to learn about the average product of managers for Indian producers. We also complement these data sets using the summary statistics on the US economy from Hsieh and Klenow (2011).

4.2 Parameters and Moments

In the model, we have the following parameters to calibrate: $\mu, \sigma, \zeta, \chi, \kappa, \gamma, \theta, \alpha$, and z. First, we abstract from pledgability and therefore set $\chi = 0$. Following the long-standing micro R&D literature, we take the curvature of the innovation production function to be $\zeta = 0.5$. The rest of the parameters are calibrated by targeting the moments reported in Table 2.

Moment	**Data**	**Model**
$\frac{\text{mean employment for emp } >5}{\text{mean employment for emp } \leq 5}$	7.96	9.12
$\frac{\text{value added - labor costs}}{\text{gross output}}$	0.17	0.19
employment share of firms with $n \geq 5$	0.32	0.33
aggregate growth	1.1%	1.3%
life cycle profile	Figure 12	Figure 12

TABLE 2: MOMENTS TARGETED FOR INDIAN FIRMS

The calibrated parameters are given in Table 3.

Parameter	**Meaning**	**Value**
σ	curvature of efficiency	0.4
z	entry rate	0.04
κ	outside option	0.10
γ	innovation step size	1.22
θ	innovativeness	1.90
α	share of high type	0.04
μ	share of contractible tasks	0.10

TABLE 3: PARAMETER CALIBRATION FOR INDIAN FIRMS

As seen in Table 2, the model does a good job of matching the targets. The resulting Indian life-cycle profile is shown in Figures 12 and 13. The prediction of the model is that while the overall life-cycle profile of firms is completely flat as seen in the data (Figure 12), there is a subgroup of firms that have a positively sloped profile (Figure 13). However, since these firms are constrained

through the imperfect contractual environment, these firms do not grow sufficiently to push out the low-type firms, which, in the model, do not see any growth.

Discussion of the model The contractual frictions have been at the center of our analysis. Even though the literature has provided plenty of evidence on this mechanism as discussed in the Introduction, we would like to provide some additional tests using our own data. Even though there can be other potential mechanisms, such as differences in entry rate (z) or type distribution (α), a unique implication of the contractual friction is that the problem becomes more severe as the size of the pie increases, i.e., as firm size gets bigger. This would imply that marginal effort that is exerted by managers will be decreasing as firm size increases. To see if this is consistent with the data, Figure 15 plots the average value added per managerial effort. Both the model and the data seem to generate a concave profile. This emerges from our model because it is much harder to write the required contract to compensate the managers. When the contractual frictions are removed, i.e., $\mu \to 1$, the model converges to the benchmark model of Klette and Kortum (2004) where the average product per manager would be completely flat.

All other mechanisms, such as the differences in entry rate or the differences in type distribution, would affect all firms symmetrically; therefore, they would not generate a concave profile as the current model does. We will further analyze the implications of other mechanisms in Section 4.4.

4.3 Comparison to the US

In this section, our goal is to compare Indian firms to US firms and diagnose the underlying differences. Our goal is to test the quantitative power of the contractual frictions in explaining the observed cross-country differences. For this, we recalibrate two parameters of the model (μ and α) to the US economy, keeping the rest of the parameters fixed at the Indian levels. These parameters for the US are chosen to match the life-cycle properties and employment share of firms with more than 20 employees (see Figure 17). The resulting parameters are reported in Table 4.

Parameter	US	India
μ	0.95	0.10
α	0.06	0.04

TABLE 4: PARAMETER CALIBRATION FOR US FIRMS

Figure 16 shows that by varying the contractual environment and the share of high type entrepreneurs, our model can explain 60% of the observed increase in employment in the US economy by the age of 31-35 ($\approx$ (2.75-1)/(4-1)). Our calibration also depicts a quite sizable difference in the contractual environment between the two countries ($\mu^{ind} = 0.1$ vs $\mu^{us} = 0.95$) and also a 50% higher fraction of high type entrepreneurs ($\alpha^{ind} = 0.04$ vs $\alpha^{us} = 0.06$).

To see the economic importance of μ and α differentially, Figure 17 plots various scenarios: The solid line shows the baseline Indian economy. The dotted blue line just introduces μ^{us} into the Indian economy while preserving α^{ind}. Figure 17 shows that changing the value of μ alone has a strong effect on firm dynamics. In particular, it shows that having a larger fraction of contractible tasks (setting $\mu^{ind} = \mu^{us}$) can explain more than 50% of the observed employment increase of older firms. This is achieved because firm owners can offer a better contract to their managers and thereby induce the manager to make a greater effort. This in turn increases the incentives to expand the firm and increases its size. According to Figure 17, the role of the type distribution is quite minimal.

To see how selection is important in the model, Figure 18 plots the employment share of firms

that are 5+ years old for different values of μ. The figure implies that expansion of the firms due to a better contractual environment leads to the reallocation of workers from low types to high types, and as high-types get older, they increase their relative employment share in the economy. This margin explains the higher share of employment held by older firms in the US compared to the Indian firms.

Figure 19 also shows how selection differs between India and the US through the lens of the model, by plotting the share of low type firms within a cohort as it ages. The stark decline in the US is a sign of the strong selection, as opposed to the weak selection margin in the Indian economy. Any policy that makes the low type firms live longer would slow down this selection process and thus have a detrimental impact on aggregate productivity. The following section will analyze the role of such a policy directly.

4.4 Role of Different Margins of the Model

In this section, we will analyze the role of different mechanisms in more detail. In particular, we will examine the partial effects of various channels of the model.

Entry We first start with the entry rate. Figure 20 plots the employment share of firms 31-35 years old against various values of the entry rate, keeping all other parameters at their Indian values. Interestingly, having more entry does not lead to any increase in employment at older firms. On the contrary, more entry implies more competition and hence lowers firm size. This is because incumbent firms are losing their product lines to new entrants. Hence, the differences between Indian and US firms cannot be explained by the differences in entry rates.

Type Distribution We next turn to α, the probability of being a high type entrepreneur. Figure 21 keeps all other parameters at their Indian values and varies only α. Initially, this contributes to the employment share of older firms; however, this positive marginal effect fades away quickly because more high type entrant also implies more competition among high type incumbents. Indeed, for very large values of α, average employment at large firms even starts to decrease. Overall, average employment does not increase sufficiently enough to make it a candidate for explaining the differences between Indian and US firms. Indeed, the interesting implication is that having more talented entrepreneurs does not contribute much to the economy unless the institutional environment is improved. Therefore, it is not surprising that when we let both the contractual environment μ and the type distribution α vary across the economies, most of the differences were explained by μ in Figure 17.

Liquidity Constraint

Until now, we have assumed away the manager's ability to buy the company up front and have shown the quantitative importance of imperfect managerial contracts in understanding the differences in firm dynamics. In addition however, our model also has some potentially interesting implications for the interplay between financial development and firm dynamics. In particular, the availability of sufficient funds to managers to buy the company would be another way to get around the contractual frictions. This can be mapped for instance to venture capitalists in developed countries, who bring both money and managerial effort into the company. Even though we leave a detailed empirical analysis of this channel to future research, we briefly point out the effects on firm dynamics if managers are able to buy the firm up front. In Figure 22, we plot the average employment of firms 31-35 years old against different values of χ, which resembles the ability of managers to borrow. The figure shows that development of capital markets could be a powerful mechanism to improve firm dynamics in developing countries. In other words, improvement in credit markets could be a substitute for improvements in contractual frictions.

5 Conclusion

This paper studies the reasons behind the stark differences in firm dynamics across countries, as documented in Hsieh and Klenow (2011). We focus on manufacturing firms in India and analyze the stagnant firm behavior. We show that the poor life-cycle behavior in India could be explained by the lack of firm selection, wherein firms with little growth potential survive because innovative firms do not expand sufficiently quickly to replace them. Our theory stresses the role of imperfect managerial contracts as the main cause for the insufficient expansion by the high type firms. We show that if the provision of managerial effort is non-contractible, firms will endogenously limit managerial authority to reduce the extent of hold-up. Since large producers will have a higher incentive to put such inefficient monitoring policies in place, the returns to innovation decline rapidly. Improvements in the degree of contract enforcement will therefore raise the returns to growth and increase the degree of creative destruction. This argument is in line with the empirical findings of Bloom and Van Reenen (2007, 2010).

Our analysis so far suggests the following conclusions: First, the steepness of the life-cycle growth trajectory of US firms (conditional on survival) reflects larger incumbent innovation incentives in the US, driven by an efficient managerial technology that allows firms to scale up easily. The fact that US firms can write better managerial contracts allows them to incentivize their managerial personnel and expand into new products without facing increasing marginal managerial costs. Second, US aggregate productivity growth is mostly driven by incumbents' innovation incentives, which induce the rapid growth of successful firms and early exit of unsuccessful ones. Indian firms, by contrast, simply earn too little infra-marginal rents to generate sufficient innovation incentives for steep life-cycle growth. Through the lens of our model, this is due to an imperfect contractual environment. Third, the policies that aim to support small businesses might indeed be detrimental to aggregate productivity, as these policies slow down the creative destruction and selection process that is needed in India.

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6 Appendix

6.1 Figures

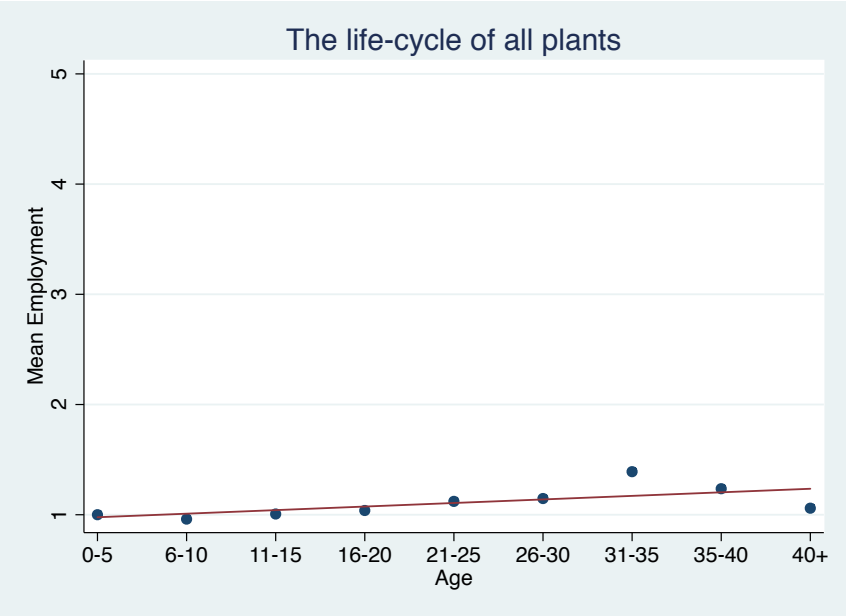


FIGURE 1: THE LIFE-CYCLE OF MANUFACTURING PLANTS IN INDIA

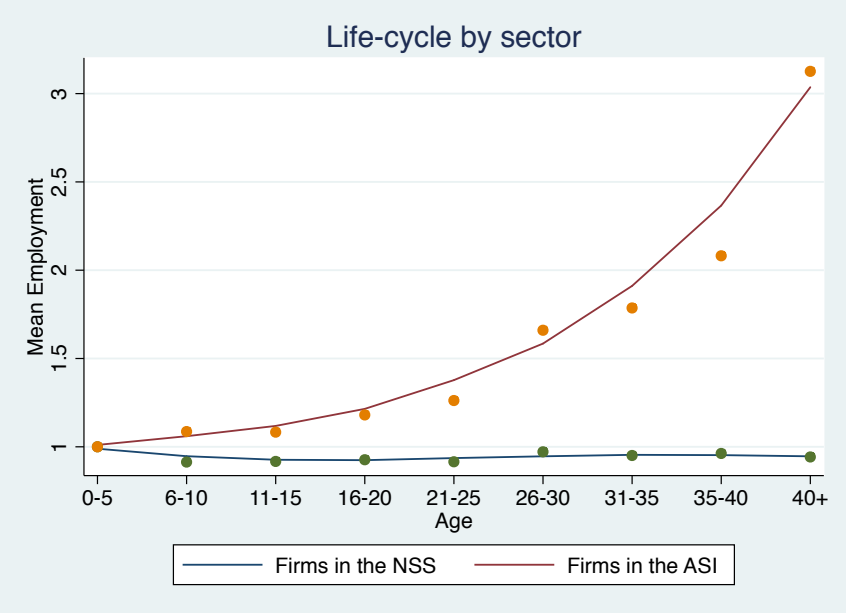


FIGURE 2: THE LIFE-CYCLE OF MANUFACTURING PLANTS IN INDIA: ASI VERSUS NSS

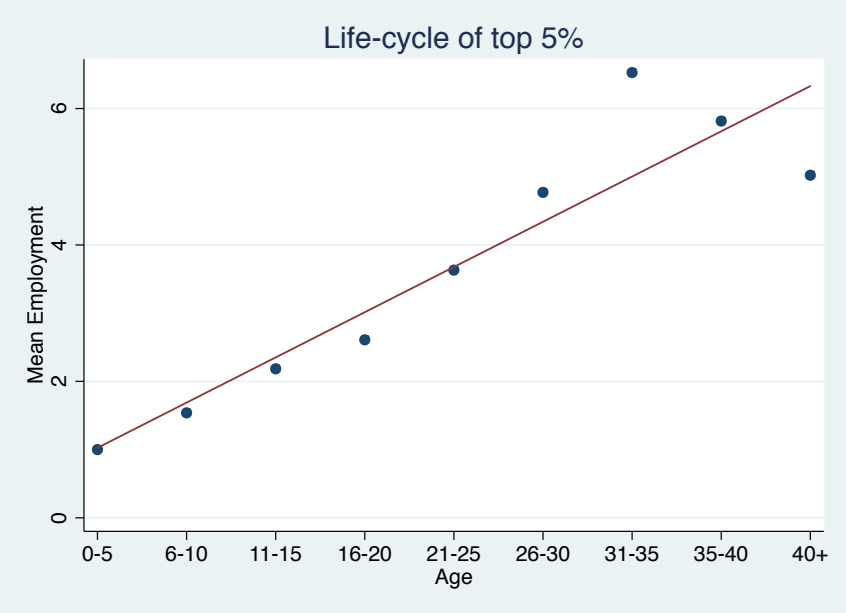


FIGURE 3: THE LIFE-CYCLE OF THE TOP 5% OF FIRMS IN INDIA

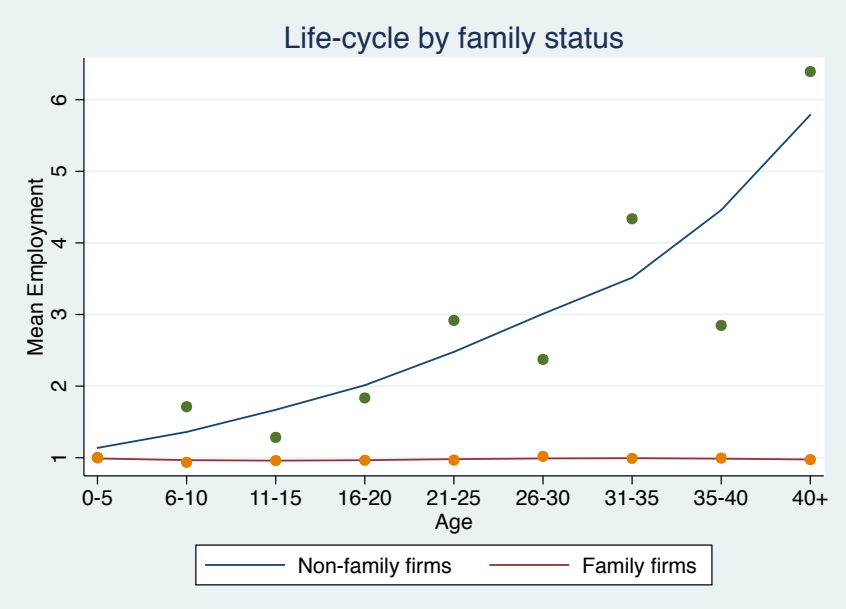


FIGURE 4: THE LIFE-CYCLE OF FAMILY FIRMS VERSUS NON-FAMILY FIRMS

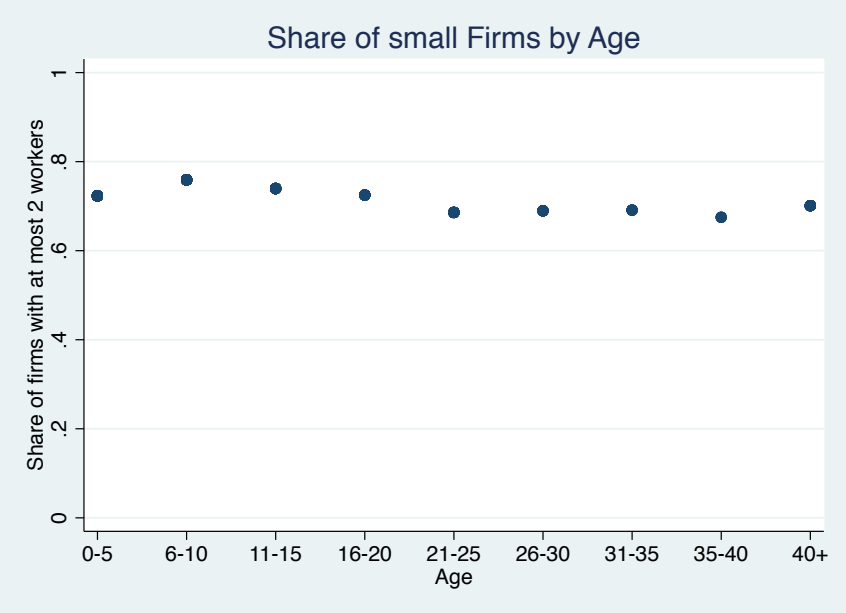


FIGURE 5: THE SHARE OF SMALL FIRMS IN THE INDIAN ECONOMY

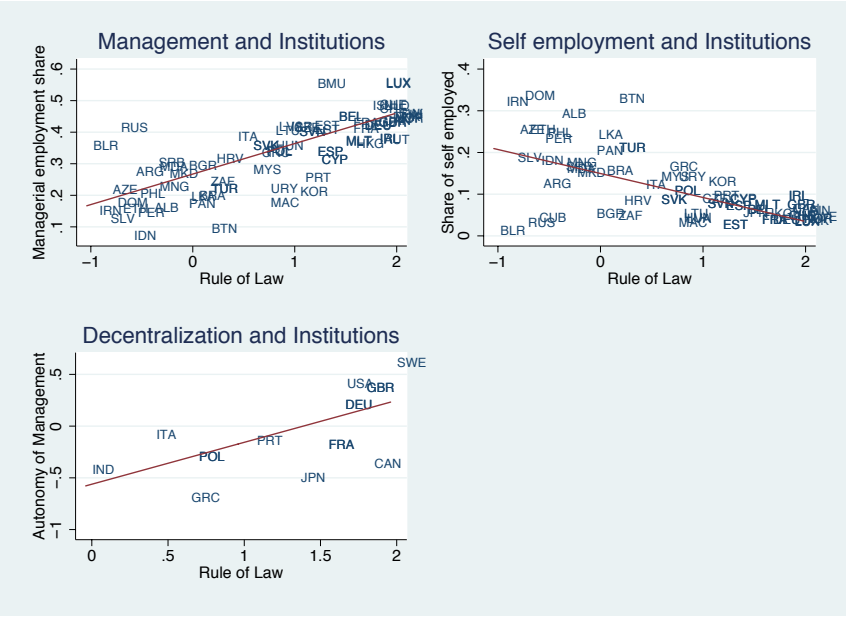


FIGURE 6: MANAGEMENT AND CONTRACTS

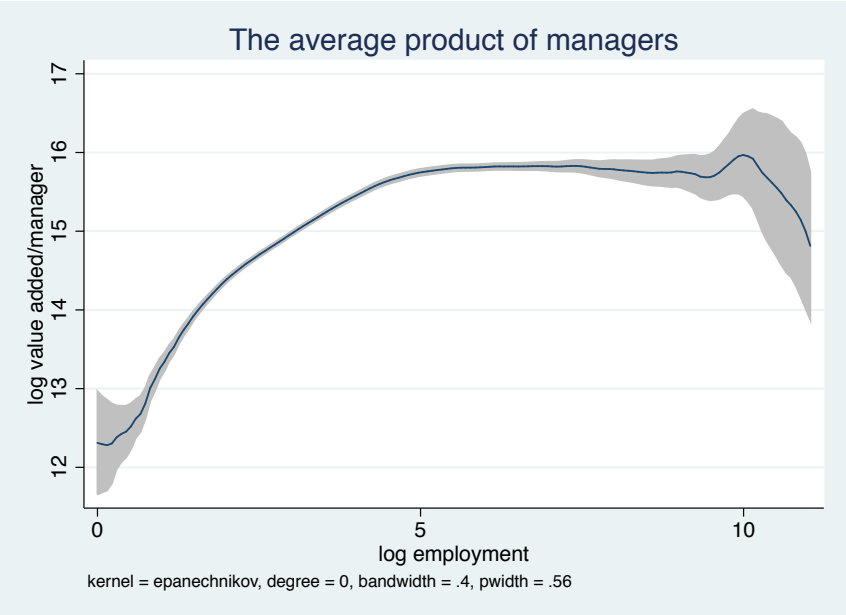


FIGURE 7: THE AVERAGE PRODUCT OF MANAGERS IN THE CROSS-SECTION OF FIRMS

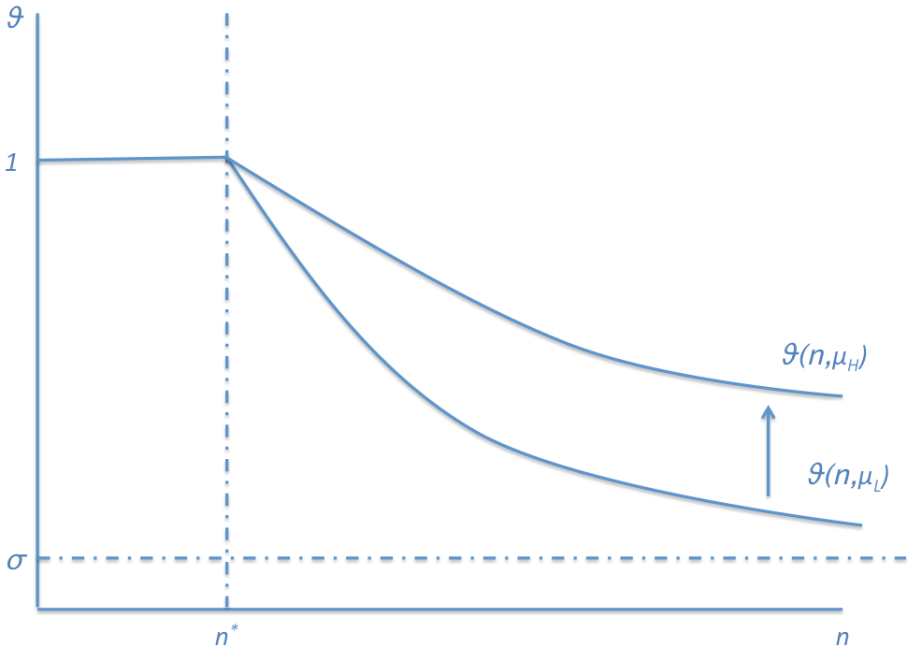


FIGURE 8: THE OPTIMAL LEVEL OF AUTHORITY $\vartheta(n,\mu)$

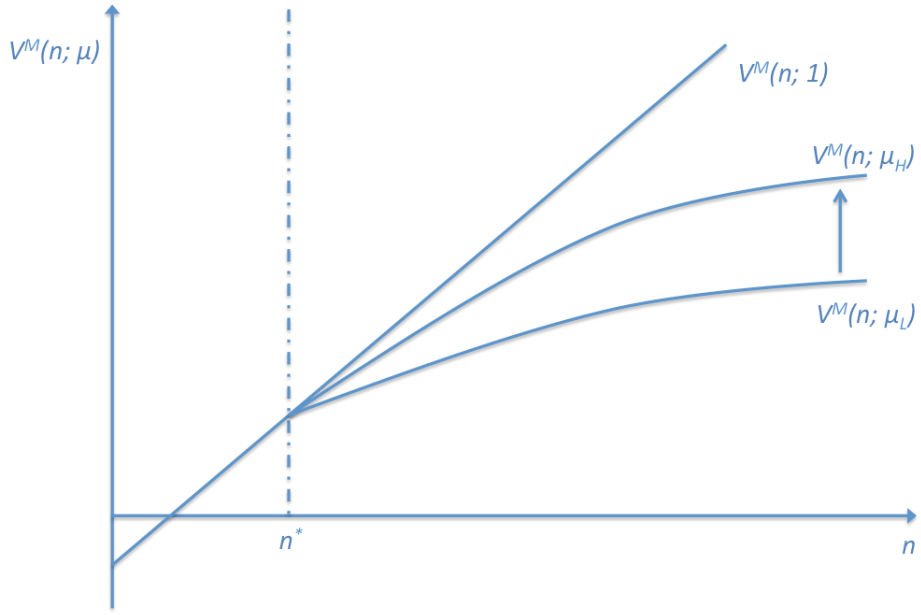


FIGURE 9: THE VALUE FUNCTION $V(n,\mu)$

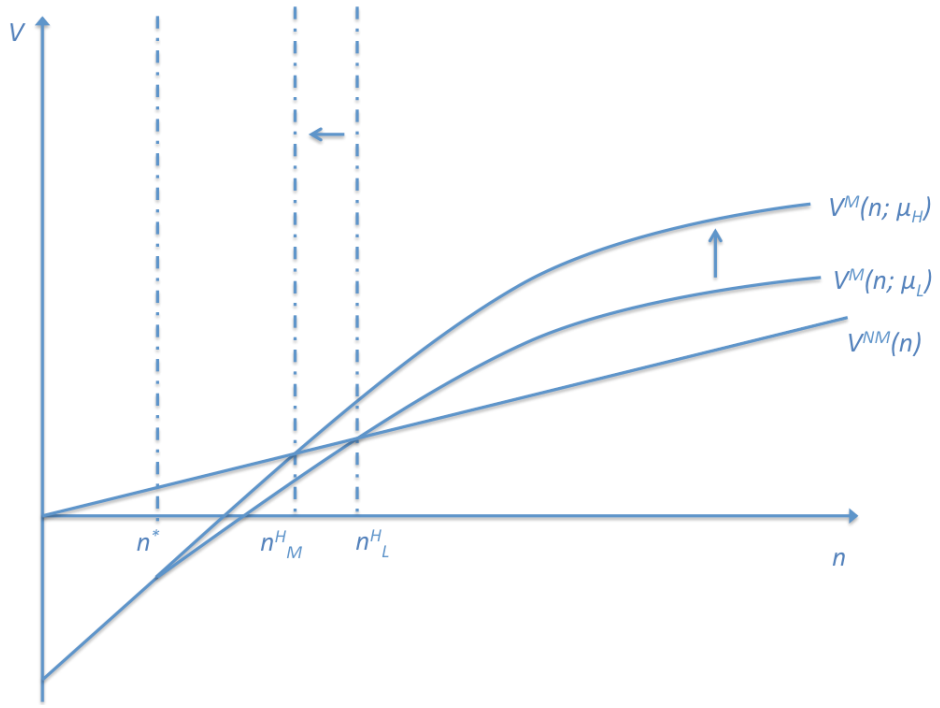


FIGURE 10: MANAGERIAL DEMAND

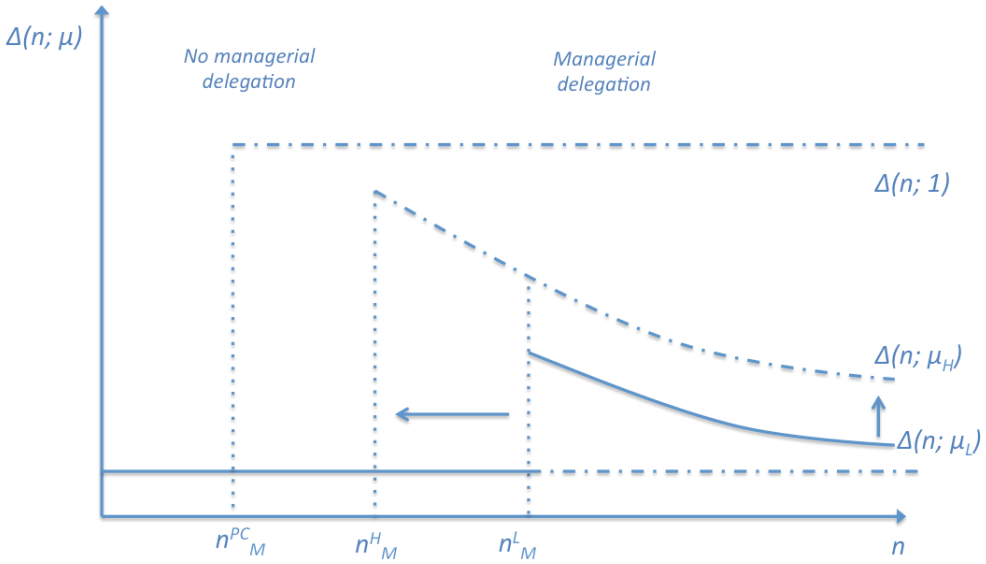


FIGURE 11: CONTRACTS AND THE INCENTIVES TO EXPAND

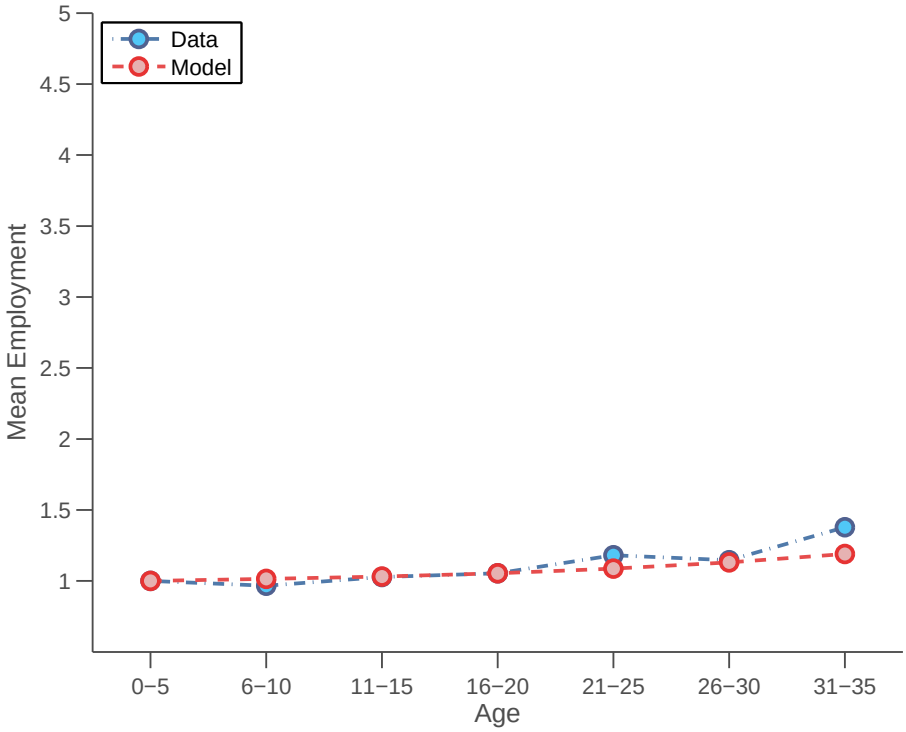


FIGURE 12: LIFE CYCLE OF INDIAN FIRMS

FIGURE 13: LIFE CYCLE OF INDIAN FIRMS

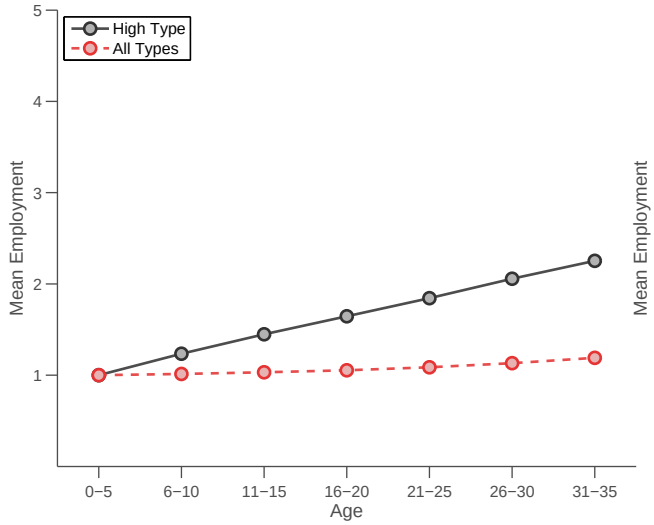
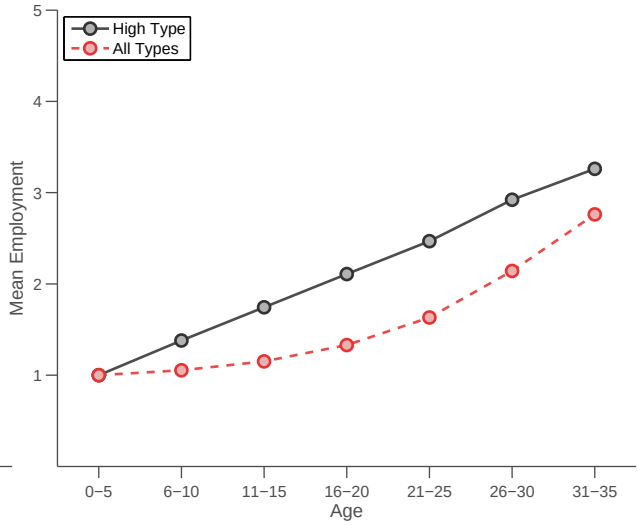


FIGURE 14: LIFE CYCLE OF US FIRMS



Notes: Figure 13 plots the life-cycle of Indian firms. The red dotted line shows the overall economy, whereas the solid line depicts only the high type firms. Figure 17 plots the same figure for US firms.

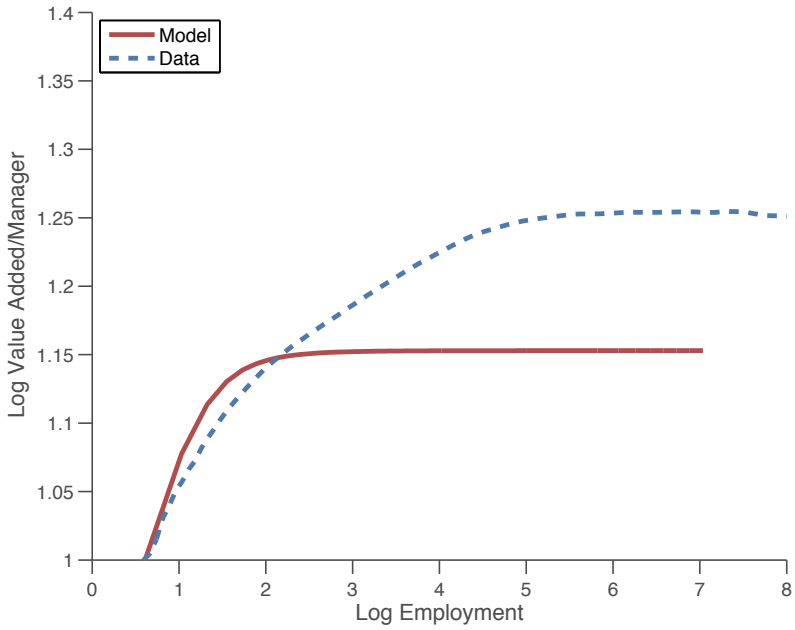


FIGURE 15: AVERAGE PRODUCT OF MANAGER: DATA VS MODEL

FIGURE 16: LIFE CYCLE OF US FIRMS: DATA VS MODEL

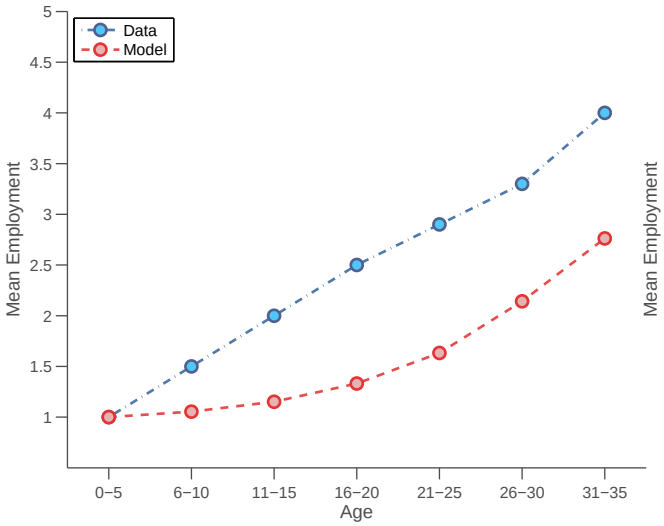
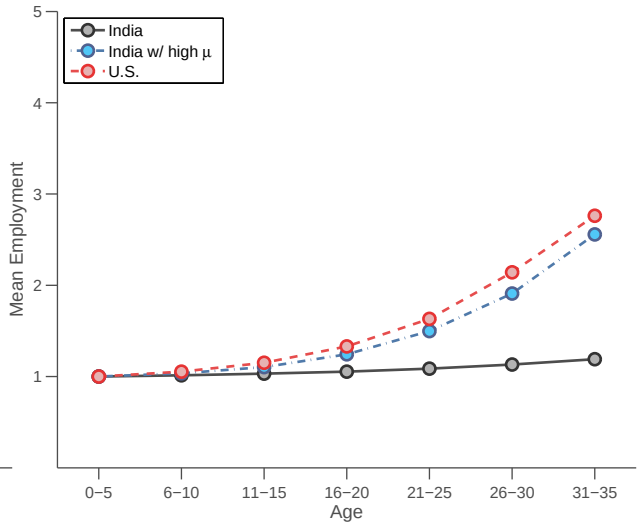


FIGURE 17: IMPROVING THE CONTRACTUAL ENVIRONMENT (μ) VS FIRM'S LIFE CYCLE



Notes: Figure 16 recalibrates the model by changing μ and α. Figure 17 plots the calibrated life-cycle dynamics of Indian and US firms. After calibrating the Indian economy, we recalibrate the US economy by changing only the entry rate α and contractual parameter μ. The intermediate blue line shows a hypothetical Indian economy with the US contractual environment $\mu^{ind} = \mu^{us}$.

FIGURE 18: EMPLOYMENT SHARE OF 5+ FIRMS VS μ

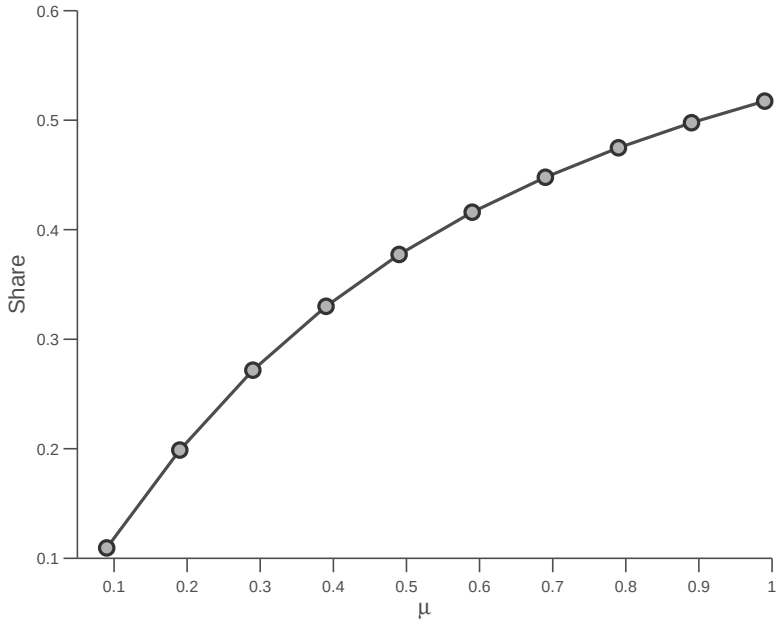


FIGURE 19: NUMBER OF LOW-TYPE FIRMS BY AGE

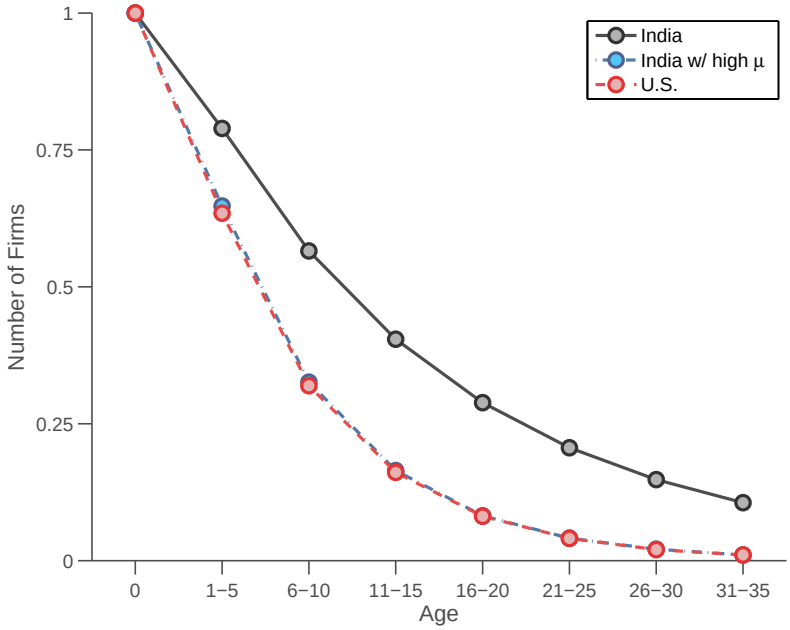


FIGURE 20: ENTRY RATE z VS EMPLOYMENT PROFILE OF 31-35 YEAR-OLD FIRMS

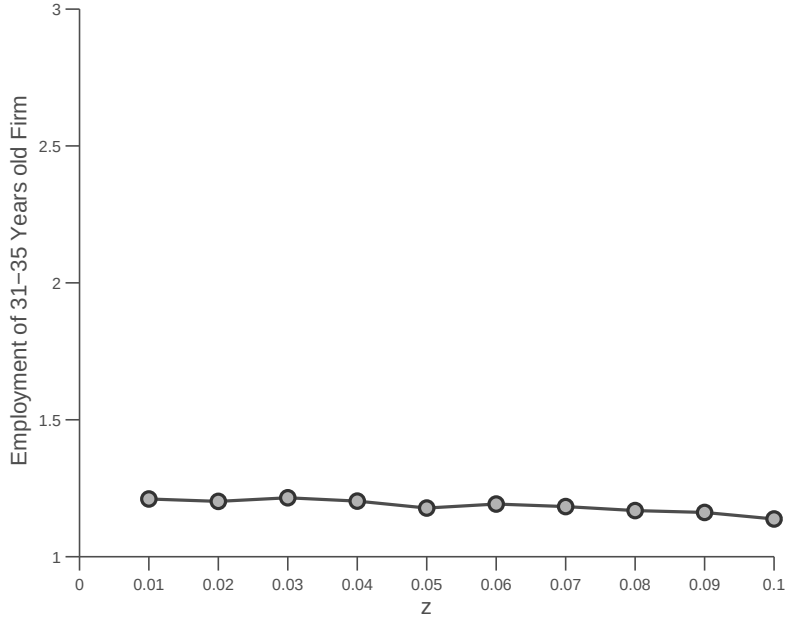


FIGURE 21: TYPE DISTRIBUTION α VS EMPLOYMENT PROFILE OF 31-35 YEAR-OLD FIRMS

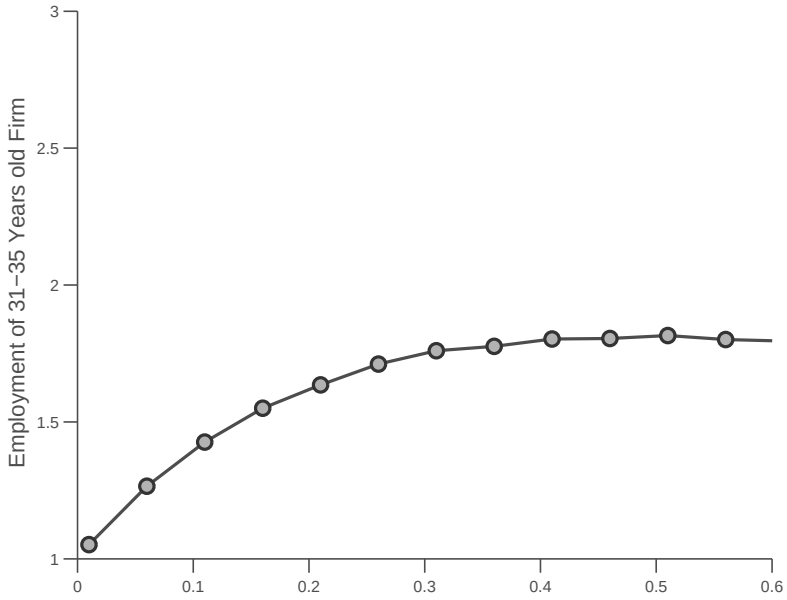


FIGURE 22: TYPE DISTRIBUTION χ VS EMPLOYMENT PROFILE OF 31-35 YEAR-OLD FIRMS

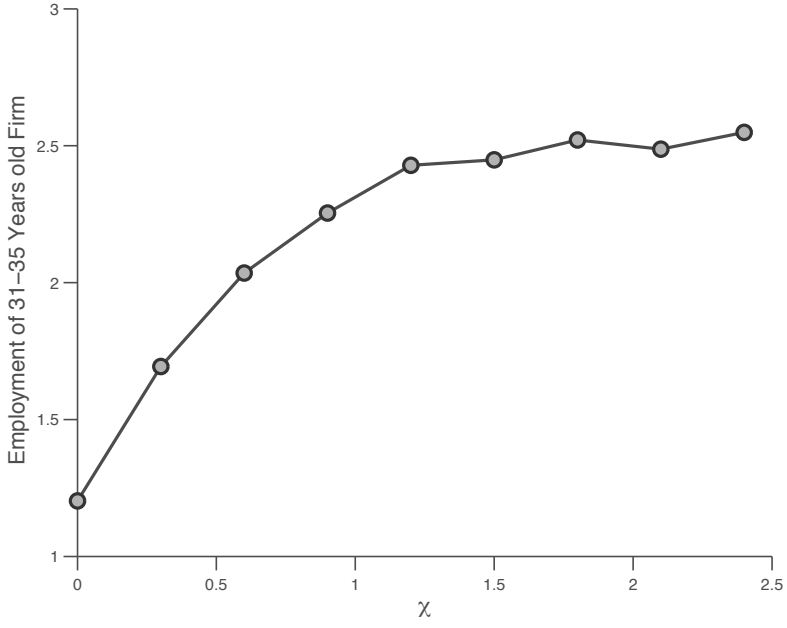


FIGURE 24: THE SHARE OF ASI FIRMS BY AGE GROUP

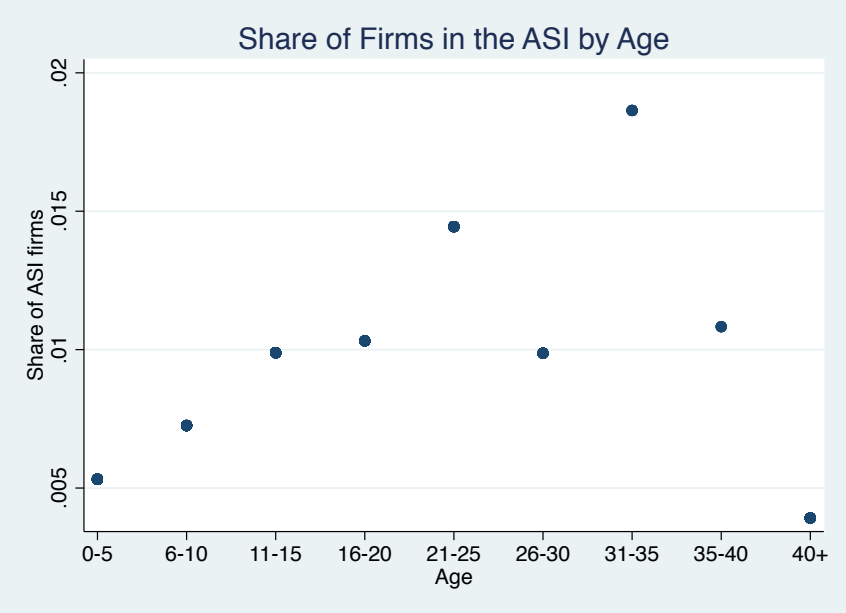


FIGURE 23: THE FIRMS SIZE DISTRIBUTION IN INDIA

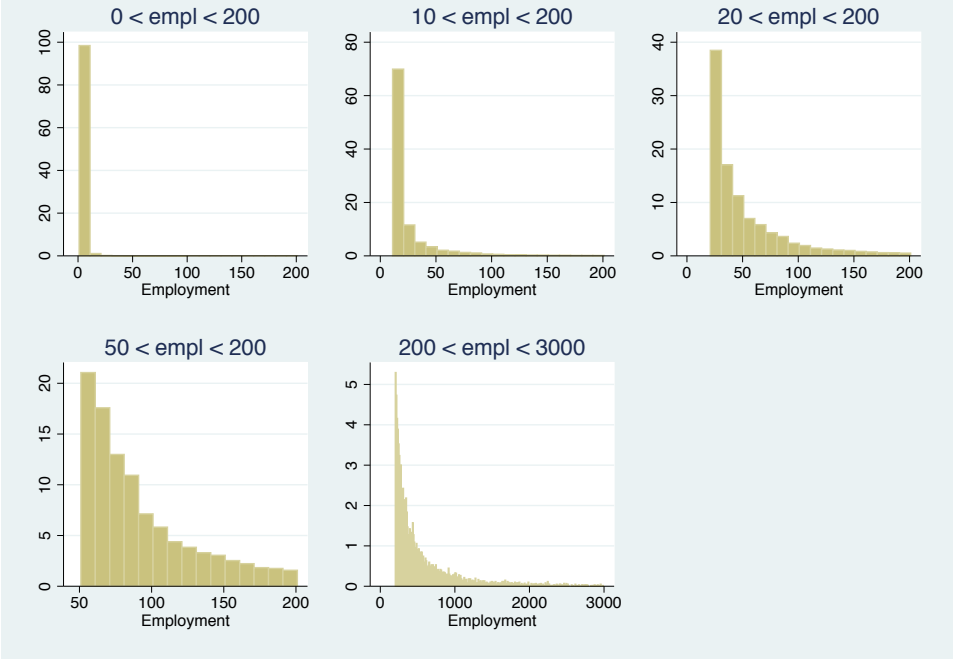


FIGURE 25: THE SHARE OF ASI FIRMS BY AGE GROUP

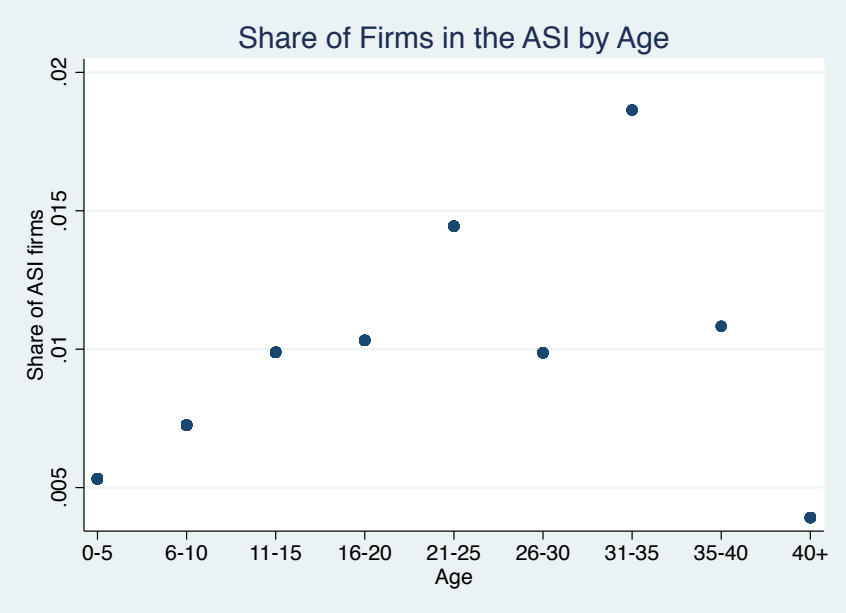


FIGURE 26: THE LIFE-CYCLE OF THE TOP FIRMS IN INDIA

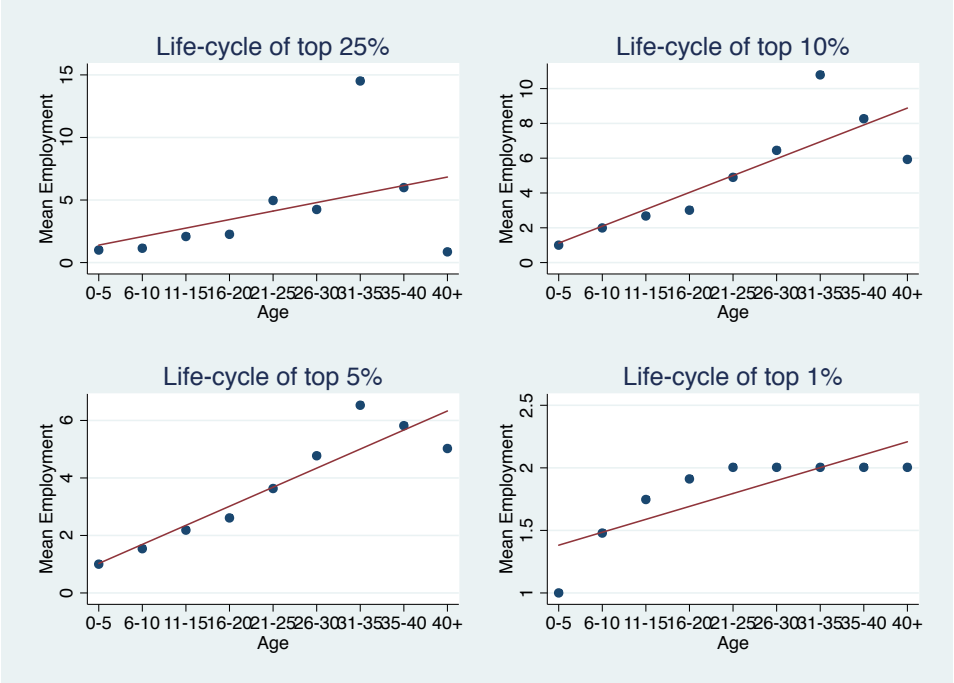


FIGURE 27: THE EVOLUTION OF THE TOP FIRMS IN INDIA



6.2 Replicating Hsieh and Olken (2014)

Figure 23 replicates the analysis of Hsieh and Olken (2014) for the firm size distribution in India. Despite the different sample (we use data from 1995, they use data from 2010), the general shape of the distribution looks similar. It is apparent that essentially all firms in India have at most 10 employees and that the distribution is unimodal and smoothly declines. We also do not find any evidence of a missing middle.

6.3 Additional Evidence for Section 2.1

Figure 25 plots the share of firms in ASI by age. It is seen that the share of ASI firms is very low — on average about 1%. It is slightly increasing by age, which we interpret as NSS firms having a higher probability of exit. Interestingly, there are few old firms in the ASI. While this might be due to measurement issues, it also hints at the importance of cohort effects in that the only remaining firms that entered the economy in 1995 are not part of the formal manufacturing sector.

In Figure 26 we provide some robustness to Figure 3 by replicating the basic pattern for different cut-offs for the upper tail of the firm observations in the data. As in Figure 3 we see that irrespective of the precise cut-off, the tail actually fans out, i.e., there exists a subset of firms that do grow.

Figure 27 addresses the concern of selection, i.e., what is the share of firms after sampling weights are taken into account. If sampling weights were unity (or uncorrelated with employment), the share of firms was simply equal to the share of observations. Figure 27 shows that the firm size is negatively correlated with the sampling weights (so that the share of top firms is very small). More important, there is not much systematic correlation across age. Hence, the selection across age is unlikely to play a large role in the strong upward-sloping pattern shown in Figures 26 and 3.

In Figure (7) we showed that the profitability of managerial resources is particularly high in

	Dep Variable: Average product per manager $ln(\frac{va_i}{m_i})$			
	(1)	(2)	(3)	(4)
log employment	0.327***	0.339***	0.363***	0.406***
	(0.009)	(0.009)	(0.009)	(0.013)
Industry FE	x	x	x	x
State FE		x	x	x
Age FE			x	x
Population weights				x
Observations	16,418	16,418	16,418	16,418
R-squared	0.24	0.27	0.28	0.26

	Dep Variable: Average product per managerial spending $ln(\frac{va_i}{w_m m_i})$			
	(1)	(2)	(3)	(4)
log employment	0.045***	0.058***	0.085***	0.131***
	(0.008)	(0.008)	(0.008)	(0.011)
Industry FE	x	x	x	x
State FE		x	x	x
Age FE			x	x
Population weights				x
Observations	16,284	16,284	16,284	16,284
R-squared	0.19	0.21	0.22	0.24

TABLE 5: THE AVERAGE PRODUCT OF MANAGERIAL INPUTS AND FIRM SIZE

large firms. However, Figure (7) did not include any controls. Table 5 contains the results of regressions of the form

$$ln\left(APM_i\right) = \alpha + \beta ln\left(l_i\right) + x_i'\gamma + u_i,$$

where APM is the average product of managers, measured either as value added per manager ($\frac{va}{m}$) or value added per managerial wage bill ($\frac{va}{w_m m}$), and l_i denotes total employment and x_i contains various fixed effects as controls. As seen in Table 5, the coefficient β is positive and highly significant, and hence consistent with Figure (7). Columns one to three contain the simple regression with different fixed effects. In column four we include the firm-specific population weights as weights for the regression.

6.4 The Bargaining Share

After the ex-ante payments are received and the manager has decided how many firm-specific tasks to learn, he decides how many efficiency units actually to provide in the share of tasks that are non-contractible. Let P be the bargained wage for the manager. If the parties do not agree, the manager does not get his payment P. The firm, however, can still force the manager to supply $\delta\hat{e}$ units of effort in the set of non-contractible activities. Hence, the payoff of the firm if no agreement

is reached is given by

$$\begin{aligned}\pi^{NA}\left(\left[e_C(i)\right]_0^{\mu},\left[\hat{e}_{NC}(i)\right]_{\mu}^{1},n,\delta\right) &= \frac{\gamma-1}{\gamma}\left(exp\left(\int_0^{\mu} ln\left(e_C(i)\right)di+\int_{\mu}^{1} ln\left(\delta e_{NC}(i)\right)di\right)\right)^{\sigma} Y(t)\,n\\ &= \frac{\gamma-1}{\gamma}\left(exp\left(\int_0^{1} ln\left(e(i)\right)di+ln\left(\delta^{1-\mu}\right)\right)\right)^{\sigma} Y(t)\,n\\ &= \frac{\gamma-1}{\gamma}\delta^{(1-\mu)\sigma}\left(exp\left(\int_0^{1} ln\left(e(i)\right)di\right)\right)^{\sigma} Y(t)\,n\\ &= \delta^{(1-\mu)\sigma}\pi\left(\left[e_C(i)\right]_0^{\mu},\left[\hat{e}_{NC}(i)\right]_{\mu}^{1},n\right),\end{aligned}$$

where π denotes the profit of the firm if an agreement is reached. The manager in contrast does not get anything, because his skills are firm-specific and it is too late for him to get matched with a different employer. If the parties agree, the manager gets P and the firms get $\pi - P$. Hence, Nash bargaining implies that the payment P maximizes a geometric weighted average of the respective surplus. Letting α be the bargaining weight of the manager, P is given by

$$P^{*}=\arg\max_{P}\left(\pi\left(\left[e(i)\right],n\right)-P-\pi^{NA}\left(\left[e(i)\right],n,\delta\right)\right)^{1-\alpha}P^{\alpha}.$$

This implies that

$$\begin{aligned}P &= \alpha\left[\pi\left(\left[e(i)\right],n\right)-\pi^{NA}\left(\left[e(i)\right],n,\delta\right)\right]\\ &= \alpha\left(1-\delta^{\sigma}\right)\pi\left(\left[e(i)\right],n\right) \qquad (50)\\ &= \alpha\left(1-\delta^{\sigma}\right)\frac{\gamma-1}{\gamma}\hat{e}^{\sigma}Y(t)\,n, \qquad (51)\end{aligned}$$

where $e=exp\left(\int_0^{\mu} ln\left(e_C(i)\right)di+\int_{\mu}^{1} ln\left(e_{NC}(i)\right)di\right)$. (51) is the expression in (30).

6.5 Proof of Propositions 1 and 2

Using Lemma 1 and writing (33) as $e_{NC}=e_{NC}(\vartheta,e_C)$, we can rewrite (34) as

$$V^{F}(n)\equiv\max_{\tau,\vartheta,e^{C}}(1-\vartheta)\,\pi(e_C,e_{NC},n)-\tau \qquad (52)$$

subject to

$$\begin{aligned}\vartheta\pi(e_C,e_{NC},n)-C_{NC}-C_C+\tau &= w\ [\phi]\\ \tau &\geq 0\ [\eta] \qquad (53)\\ \vartheta &\leq 1\ [\rho], \qquad (54)\end{aligned}$$

where $C_C(e_C)=\mu vnQ(t)\,e^{C}$, and ϕ,η and ρ are the respective Lagrange multipliers, where we already imposed $\alpha=1$. The three first order conditions are

$$\begin{aligned}0 &= (1-\vartheta)\left[\frac{\partial\pi}{\partial e_C}+\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial e_C}\right]+\phi\left[\vartheta\left[\frac{\partial\pi}{\partial e_C}+\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial e_C}\right]-\frac{\partial C_{NC}(e_C)}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial e_C}-\frac{\partial C_C(e_C)}{\partial e_C}\right]\\ 0 &= -\pi(e_C,e_{NC},n)+(1-\vartheta)\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial\vartheta}+\phi\left[\pi(e_C,e_{NC},n)+\vartheta\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial\vartheta}-\frac{\partial C_{NC}(e_C)}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial\vartheta}\right]-\rho\\ 0 &= -1+\phi+\eta,\end{aligned}$$

with the complementary slackness conditions

$$\begin{aligned}(\tau + LC)\,\eta &= 0 \quad (55)\\ (\alpha - \vartheta)\,\rho &= 0 \quad (56)\end{aligned}$$

and $\phi > 0$. Note that managerial optimality implies that

$$0 = \vartheta \frac{\partial \pi}{\partial e_{NC}} - \frac{\partial C_{NC}(e_{NC})}{\partial e_{NC}},$$

so that the optimality conditions read

$$\begin{aligned}0 &= (1-\vartheta)\left[\frac{\partial \pi}{\partial e_C} + \frac{\partial \pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial e_C}\right] + \phi\left[\vartheta\frac{\partial \pi}{\partial e_C} - \frac{\partial C_C(e_C)}{\partial e_C}\right] \quad (57)\\ 0 &= -\pi(e_C, e_{NC}, n) + (1-\vartheta)\frac{\partial \pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial \vartheta} + \phi\pi(e_C, e_{NC}, n) - \rho \quad (58)\\ 0 &= -1 + \phi + \eta. \quad (59)\end{aligned}$$

Hence, (57)-(59), (55), (56) and (35) are 6 equations that we can solve for the 6 unknowns $(\tau, e_C, \vartheta, \eta, \phi, \rho)$.

It is useful to characterize everything in terms of the multiplier on the liquidity constraint η and the level of authority ϑ, which are at the heart of the contracting problem. Using (59) to substitute for ϕ and (33) to get

$$\begin{aligned}\frac{\partial \pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial e_C} &= \frac{\partial ln(\pi)}{\partial ln(e_{NC})}\frac{\pi}{e_{NC}}\frac{\partial ln(e_{NC})}{\partial ln(e_C)}\frac{e_{NC}}{e_C} = (1-\mu)\sigma\frac{\pi}{e_{NC}}\frac{\mu\sigma}{1-(1-\mu)\sigma}\frac{e_{NC}}{e_C}\\ &= \frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}\frac{\partial \pi}{\partial e_C},\end{aligned}$$

we can rewrite (57), the optimality condition for e_C, as

$$\begin{aligned}0 &= (1-\vartheta)\left[\frac{\partial \pi}{\partial e_C} + \frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}\frac{\partial \pi}{\partial e_C}\right] + (1-\eta)\left[\vartheta\frac{\partial \pi}{\partial e_C} - \frac{\partial C_C(e_C)}{\partial e_C}\right]\\ &= \left[\frac{(1-\vartheta)}{1-(1-\mu)\sigma} + (1-\eta)\vartheta\right]\frac{\partial \pi}{\partial e_C} - (1-\eta)\frac{\partial C_C(e_C)}{\partial e_C},\end{aligned}$$

so that

$$\frac{\partial C_C(e_C)}{\partial e_C} = \left[\vartheta + \frac{(1-\vartheta)}{(1-(1-\mu)\sigma)(1-\eta)}\right]\frac{\partial \pi}{\partial e_C} \quad (60)$$

Note that (60) uniquely determines $e_C = e_C(\vartheta, \eta)$. As the cost function and the profit function have constant elasticity, we get that

$$\begin{aligned}C_C &= \frac{\partial C_C(e_C)}{\partial e_C}e_C = \left[\vartheta + \frac{(1-\vartheta)}{(1-(1-\mu)\sigma)(1-\eta)}\right]\frac{\partial \pi}{\partial e_C}e_C\\ &= \left[\vartheta + \frac{(1-\vartheta)}{(1-(1-\mu)\sigma)(1-\eta)}\right]\sigma\mu\pi.\end{aligned}$$

Hence, the participation constraint implies that transfers are given by

$$\begin{aligned}\tau &= w-(\vartheta\pi-C_{NC}-C_C)\\ &= w-\left((1-(1-\mu)\sigma)\vartheta\pi-\left[\vartheta+\frac{(1-\vartheta)}{(1-(1-\mu)\sigma)(1-\eta)}\right]\sigma\mu\pi\right)\\ &= w-\left((1-\sigma)\vartheta-\left(\frac{(1-\vartheta)\sigma\mu}{(1-(1-\mu)\sigma)(1-\eta)}\right)\right)\pi, \end{aligned} \tag{61}$$

so that the value of the firm is given by

$$\begin{aligned}V^M(n) &= (1-\vartheta)\pi-w\\ &= \left[(1-\sigma)\vartheta+\left[1-\frac{\sigma\mu}{(1-(1-\mu)\sigma)(1-\eta)}\right](1-\vartheta)\right]\pi-w. \end{aligned} \tag{62}$$

Note that $\pi=\pi(e_C,e_{NC})$ is fully determined given ϑ and η. Hence, (62) determines the value of the firm given (ϑ,η). It is also clear from the above that we can solve for ρ from (56).

Suppose first that the liquidity constraint is indeed slack. From (58) the optimal level of authority solves

$$\rho = (1-\vartheta)\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial\vartheta}>0.$$

Hence, (56) implies that $\vartheta=1$.*Equation* (60) then implies that $\frac{\partial C_C(e_C)}{\partial e_C}=\frac{\partial\pi}{\partial e_C}$, i.e. the marginal returns of contractual investments are equal to the marginal costs. Hence, using (33), we get

$$\begin{aligned}\frac{\partial C_C(e_C)}{\partial e_C}=\mu v_L Q(t)n &= \sigma\mu\frac{\pi}{e_C}=\sigma\mu\frac{\frac{\gamma-1}{\gamma}\left(e_C^{\mu}e_{NC}^{1-\mu}\right)^{\sigma}Y(t)n}{e_C}\\ &= \sigma\mu\frac{\gamma-1}{\gamma}\frac{e_C^{\mu\sigma}\left[\frac{\sigma}{v_L}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}e_C^{\mu\sigma}\right]^{\frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}}Y(t)n}{e_C}\\ &= \nu_L\mu Q(t)n\frac{\left[\frac{\sigma}{v_L}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}e_C^{\mu\sigma}\right]^{\frac{1}{1-(1-\mu)\sigma}}}{e_C}. \end{aligned}$$

Rearranging terms yields

$$e_C=e_{NC}=e^{FB}=\left(\frac{\sigma}{v_L}\frac{Y(t)}{Q(t)}\frac{\gamma-1}{\gamma}\right)^{\frac{1}{1-\sigma}},$$

so that

$$\begin{aligned}\pi &= \pi^{FB}=\frac{\gamma-1}{\gamma}\left(e^{FB}\right)^{\sigma}Y(t)n\\ &= \frac{\gamma-1}{\gamma}\left(e_{NM}(1)\left(\frac{v_H}{v_L}\right)^{\frac{1}{1-\sigma}}\right)^{\sigma}Y(t)n\\ &= \left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}}\frac{\gamma-1}{\gamma}\left(e_{NM}(1)\right)^{\sigma}Y(t)n\\ &= \left(\frac{v_H}{v_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}Y(t)n. \end{aligned}$$

The value of the firms follows directly from (62). This solution is the correct one, as long as the liquidity constraint is indeed slack. This proves Proposition 1.

From (61) we get that

$$\begin{aligned}\tau &= w-(1-\sigma)\,\pi\,(n)\\ &= w-(1-\sigma)\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}Y\,(t)\,n\end{aligned}$$

Hence, this solution is feasible as long as $\tau \geq 0$, i.e.

$$w-(1-\sigma)\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}Y\,(t)\,n \quad \geq \quad 0,$$

which yields

$$n \leq \frac{w}{(1-\sigma)\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}Y\,(t)} = \frac{1}{(1-\sigma)\,\gamma\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}\frac{Y(t)}{Q(t)}} = n^*.$$

For all $n > n^*$ the liquidity constraint is binding. From (61) we now have

$$\tau \;=\; w-\left((1-\sigma)\,\vartheta-\left[\frac{(1-\vartheta)\,\sigma\mu}{(1-(1-\mu)\,\sigma)\,(1-\eta)}\right]\right)\pi = 0.$$

Rearranging terms yields

$$w \;=\; \left((1-\sigma)\,\vartheta-\left[\frac{(1-\vartheta)\,\sigma\mu}{(1-(1-\mu)\,\sigma)\,(1-\eta)}\right]\right)\pi,$$

so that

$$n^*\,(1-\sigma)\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}Y\,(t) \;=\; \left((1-\sigma)\,\vartheta-\left[\frac{(1-\vartheta)\,\sigma\mu}{(1-(1-\mu)\,\sigma)\,(1-\eta)}\right]\right)\pi \tag{63}$$

$$n^* \;=\; \frac{(1-\sigma)\,\vartheta-\left[\frac{(1-\vartheta)\sigma\mu}{(1-(1-\mu)\sigma)(1-\eta)}\right]}{1-\sigma}\,\frac{\pi}{\left(\frac{\nu_H}{\nu_L}\right)^{\frac{\sigma}{1-\sigma}}\pi^{NM}Y\,(t)} \tag{64}$$

$$\frac{n^*}{n} \;=\; \frac{\left((1-\sigma)\,\vartheta-\left[\frac{(1-\vartheta)\sigma\mu}{(1-(1-\mu)\sigma)(1-\eta)}\right]\right)}{1-\sigma}\left(\frac{1}{\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}}}\left(\frac{e_C}{e_{NM}}\right)^{\mu}\left(\frac{e_{NC}}{e_{NM}}\right)^{1-\mu}\right)^{\sigma} \tag{65}$$

We also note that $\vartheta < 1$ by construction. Hence, $\rho = 0$ so that the optimal level of authority is given by (58)

$$0 = -\pi\,(e_C, e_{NC}, n) + (1-\vartheta)\,\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial\vartheta} + (1-\eta)\,\pi\,(e_C, e_{NC}, n)\,.$$

Using

$$\begin{aligned}\frac{\partial\pi}{\partial e_{NC}}\frac{\partial e_{NC}}{\partial\vartheta} &= \frac{\partial ln\,(\pi)}{\partial ln\,(e_{NC})}\frac{\pi}{e_{NC}}\frac{\partial ln\,(e_{NC})}{\partial ln\,(\vartheta)}\frac{e_{NC}}{\vartheta}\\ &= \frac{(1-\mu)\,\sigma}{1-(1-\mu)\,\sigma}\frac{\pi}{\vartheta},\end{aligned}$$

we get

$$0=\left[\frac{(1-\vartheta)}{\vartheta}\frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}-\eta\right]\pi\left(e_C,e_{NC},n\right).$$

Hence,

$$\eta=\frac{(1-\vartheta)}{\vartheta}\frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}. \tag{66}$$

Note that (66) defines a schedule $\vartheta=\vartheta(\eta)$ with $\vartheta'(\eta)<0$ and

$$(1-\mu)\sigma\leq\vartheta(\eta)\leq 1.$$

The optimal level of contractual effort solves (60)

$$\frac{\partial C_C(e_C)}{\partial e_C}=\left[\vartheta+\frac{(1-\vartheta)}{(1-(1-\mu)\sigma)(1-\eta)}\right]\frac{\partial\pi}{\partial e_C}.$$

Using (66) we get that

$$\begin{aligned}\vartheta+\frac{(1-\vartheta)}{(1-(1-\mu)\sigma)(1-\eta)} &= \vartheta\left(1+\frac{(1-\vartheta)}{(\vartheta-(1-\mu)\sigma)}\right)\\ &= \vartheta\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)\\ &\equiv \gamma(\vartheta,\mu).\end{aligned} \tag{67}$$

Hence,

$$\mu v_L Q(t)\,n=\gamma(\vartheta,\eta)\,\sigma\mu\frac{\gamma-1}{\gamma}\left(e_C^{\mu}e_{NC}^{1-\mu}\right)^{\sigma}\frac{Y(t)\,n}{e_C}.$$

From (33), we get

$$e_{NC}^{(1-\mu)\sigma}=\left[\vartheta\frac{\sigma}{\nu_L}\frac{Y(t)}{Q(t)}\frac{\gamma-1}{\gamma}e_C^{\mu\sigma}\right]^{\frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}},$$

so that

$$\begin{aligned}1 &= \gamma(\vartheta,\eta)\frac{\sigma}{\nu_L}\frac{Y(t)}{Q(t)}\frac{\gamma-1}{\gamma}e_C^{\mu\sigma}\left[\vartheta\frac{\sigma}{\nu_L}\frac{Y(t)}{Q(t)}\frac{\gamma-1}{\gamma}e_C^{\mu\sigma}\right]^{\frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}}\frac{1}{e_C}\\ &= \gamma(\vartheta,\eta)\,\vartheta^{\frac{(1-\mu)\sigma}{1-(1-\mu)\sigma}}\left[\frac{\sigma}{\nu_L}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}e_C^{\mu\sigma}\right]^{\frac{1}{1-(1-\mu)\sigma}}\frac{1}{e_C}.\end{aligned}$$

Hence,

$$\begin{aligned}e_C^{1-(1-\mu)\sigma} &= \gamma(\vartheta,\eta)^{1-(1-\mu)\sigma}\,\vartheta^{(1-\mu)\sigma}\frac{\sigma}{\nu_L}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}e_C^{\mu\sigma}\\ e_C^{1-\sigma} &= \gamma(\vartheta,\eta)^{1-(1-\mu)\sigma}\,\vartheta^{(1-\mu)\sigma}\frac{\sigma}{\nu_L}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}\\ &= \gamma(\vartheta,\eta)^{1-(1-\mu)\sigma}\,\vartheta^{(1-\mu)\sigma}\frac{\nu_H}{\nu_L}\frac{\sigma}{\nu_H}\frac{\gamma-1}{\gamma}\frac{Y(t)}{Q(t)}\\ &= \gamma(\vartheta,\eta)^{1-(1-\mu)\sigma}\,\vartheta^{(1-\mu)\sigma}\frac{\nu_H}{\nu_L}e_{NM}^{1-\sigma},\end{aligned}$$

so that

$$\left(\frac{e_C}{e_{NM}}\right)^{1-\sigma} = \gamma\left(\vartheta,\eta\right)^{1-(1-\mu)\sigma}\vartheta^{(1-\mu)\sigma}\frac{\nu_H}{\nu_L}. \tag{68}$$

Similarly,

$$\begin{aligned}
\frac{e_{NC}}{e_{NM}} &= \left[\vartheta\frac{\sigma}{\nu_L}\frac{\gamma-1}{\gamma}\frac{Y\left(t\right)}{Q\left(t\right)}e_C^{\mu\sigma}\right]^{\frac{1}{1-(1-\mu)\sigma}}\frac{1}{e_{NM}} \\
&= \left[\vartheta\right]^{\frac{1}{1-(1-\mu)\sigma}}\left[\frac{\nu_H}{\nu_L}\left(e_{NM}\right)^{1-\sigma}e_C^{\mu\sigma}\right]^{\frac{1}{1-(1-\mu)\sigma}}\frac{1}{e_{NM}} \\
&= \left[\vartheta\right]^{\frac{1}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-(1-\mu)\sigma}}\left(e_{NM}\right)^{\frac{-\mu\sigma}{1-(1-\mu)\sigma}}\left[e_C\right]^{\frac{\mu\sigma}{1-(1-\mu)\sigma}} \\
&= \left[\vartheta\right]^{\frac{1}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-(1-\mu)\sigma}}\left(\frac{e_C}{e^{NM}}\right)^{\frac{\mu\sigma}{1-(1-\mu)\sigma}}.
\end{aligned} \tag{69}$$

Hence, we can solve for ϑ from (63) using (66) and the expressions for $\frac{e_{NC}}{e^{FB}}$ and $\frac{e_C}{e^{FB}}$. In particular, total efficiency (relative to the first best) is

$$\begin{aligned}
\frac{e_C^{\mu}e_{NC}^{1-\mu}}{e_{NM}} &= \left(\frac{e_C}{e_{NM}}\right)^{\mu}\left(\left[\vartheta\right]^{\frac{1}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-(1-\mu)\sigma}}\left(\frac{e_C}{e_{NM}}\right)^{\frac{\mu\sigma}{1-(1-\mu)\sigma}}\right)^{1-\mu} \\
&= \left[\vartheta\right]^{\frac{1-\mu}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1-\mu}{1-(1-\mu)\sigma}}\left(\frac{e_C}{e_{NM}}\right)^{\mu}\left(\frac{e_C}{e_{NM}}\right)^{\frac{\mu\sigma(1-\mu)}{1-(1-\mu)\sigma}} \\
&= \left[\vartheta\right]^{\frac{1-\mu}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1-\mu}{1-(1-\mu)\sigma}}\left(\frac{e_C}{e_{NM}}\right)^{\frac{\mu}{1-(1-\mu)\sigma}} \\
&= \left[\vartheta\right]^{\frac{1-\mu}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1-\mu}{1-(1-\mu)\sigma}}\left(\gamma\left(\vartheta,\eta\right)^{\frac{1-(1-\mu)\sigma}{1-\sigma}}\vartheta^{\frac{(1-\mu)\sigma}{1-\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}}\right)^{\frac{\mu}{1-(1-\mu)\sigma}} \\
&= \gamma\left(\vartheta,\eta\right)^{\frac{\mu}{1-\sigma}}\vartheta^{\frac{1-\mu}{1-(1-\mu)\sigma}\left(1+\frac{\sigma\mu}{1-\sigma}\right)}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-(1-\mu)\sigma}\left(1-\mu+\frac{\mu}{1-\sigma}\right)} \\
&= \gamma\left(\vartheta,\eta\right)^{\frac{\mu}{1-\sigma}}\vartheta^{\frac{1-\mu}{1-\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}}
\end{aligned}$$

Using (67) we get

$$\frac{1}{\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}}}\frac{e_C^{\mu}e_{NC}^{1-\mu}}{e^{FB}} = \left(\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta-\left(1-\mu\right)\sigma}\right)^{\mu}\vartheta\right)^{\frac{1}{1-\sigma}} \tag{70}$$

Hence,

$$\begin{aligned}
\frac{n^*}{n} &= \frac{\left(\left(1-\sigma\right)\vartheta-\left[\frac{(1-\vartheta)\sigma\mu}{(1-(1-\mu)\sigma)(1-\eta)}\right]\right)}{1-\sigma}\left(\frac{1}{\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}}}\left(\frac{e_C}{e_{NM}}\right)^{\mu}\left(\frac{e_{NC}}{e_{NM}}\right)^{1-\mu}\right)^{\sigma} \\
&= \frac{1}{\left(1-\sigma\right)}\left(\left(1-\sigma\right)\vartheta-\left[\frac{\left(1-\vartheta\right)\sigma\mu}{\left(1-\left(1-\mu\right)\sigma\right)\left(1-\eta\right)}\right]\right)\left(\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta-\left(1-\mu\right)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}}.
\end{aligned}$$

Now note that[18]

$$\begin{aligned}
& (1-\sigma)\vartheta - \left[\frac{(1-\vartheta)\sigma\mu}{(1-(1-\mu)\sigma)(1-\eta)}\right] \\
= \; & (1-\sigma)\vartheta - \frac{(1-\vartheta)\sigma\mu\vartheta}{\vartheta-(1-\mu)\sigma} \\
= \; & \left(\frac{(1-\sigma)(\vartheta-(1-\mu)\sigma)-(1-\vartheta)\sigma\mu}{\vartheta-(1-\mu)\sigma}\right)\vartheta \\
= \; & \frac{(\vartheta-\sigma)(1-(1-\mu)\sigma)}{\vartheta-(1-\mu)\sigma}\vartheta,
\end{aligned}$$

so that

$$\begin{aligned}
\frac{n^*}{n} &= \frac{\vartheta-\sigma}{1-\sigma}\left(\frac{(1-(1-\mu)\sigma)}{\vartheta-(1-\mu)\sigma}\vartheta\right)\left(\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}} \\
&= \frac{\vartheta-\sigma}{1-\sigma}\left[\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{1-\sigma(1-\mu)}\vartheta\right]^{\frac{1}{1-\sigma}}. \qquad (71)
\end{aligned}$$

This equation determines

$$\vartheta = \vartheta\left(\frac{n}{n^*},\mu\right).$$

The function $\vartheta = \vartheta\left(\frac{n}{n^*},\mu\right)$ is decreasing in $\frac{n}{n^*}$. **Proof.** We need to show that the RHS of (71) is increasing in ϑ for $\sigma < \vartheta < 1$. Let

$$h(\vartheta) \equiv ln\left(\frac{\vartheta-\sigma}{1-\sigma}\left[\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{1-\sigma(1-\mu)}\vartheta\right]^{\frac{1}{1-\sigma}}\right).$$

Then

$$\begin{aligned}
h'(\vartheta) &= \frac{1}{\vartheta-\sigma} + \frac{1}{1-\sigma}\frac{1}{\vartheta} - \frac{1-\sigma(1-\mu)}{1-\sigma}\frac{1}{\vartheta-(1-\mu)\sigma} \\
&= \frac{1}{1-\sigma}\left(\frac{1-\sigma}{\vartheta-\sigma} + \frac{1}{\vartheta} - \frac{1-\sigma(1-\mu)}{\vartheta-(1-\mu)\sigma}\right) \\
&> \frac{1}{1-\sigma}\left(\frac{1-\sigma+\mu\sigma}{\vartheta-\sigma+\mu\sigma} + \frac{1}{\vartheta} - \frac{1-\sigma(1-\mu)}{\vartheta-(1-\mu)\sigma}\right) \\
&= \frac{1}{1-\sigma}\frac{1}{\vartheta},
\end{aligned}$$

[18] Because,

$$\begin{aligned}
& (1-\sigma)(\vartheta-(1-\mu)\sigma)-(1-\vartheta)\sigma\mu \\
= \; & (1-\sigma)(1-(1-\mu)\sigma-(1-\vartheta))-(1-\vartheta)\sigma\mu \\
= \; & (1-\sigma)(1-(1-\mu)\sigma)-(1-\sigma)(1-\vartheta)-(1-\vartheta)\sigma\mu \\
= \; & (1-\sigma)(1-(1-\mu)\sigma)-(1-\vartheta)(1-\sigma(1-\mu)) \\
= \; & (\vartheta-\sigma)(1-(1-\mu)\sigma),
\end{aligned}$$

where the inequality follows from $\frac{\partial\left(\frac{1-\sigma+\Delta}{\vartheta-\sigma+\Delta}\right)}{\partial\Delta}<0$ so that $\frac{1-\sigma+\mu\sigma}{\vartheta-\sigma+\mu\sigma}<\frac{1-\sigma}{\vartheta-\sigma}$. ■ Now we can solve for the actual effort levels and profits. From (68) and (69) we get

$$\left(\frac{e_C}{e_{NM}}\right)^{1-\sigma}=\frac{\nu_H}{\nu_L}\gamma\left(\vartheta,\eta\right)^{1-(1-\mu)\sigma}\vartheta^{(1-\mu)\sigma}=\frac{\nu_H}{\nu_L}\vartheta\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{1-(1-\mu)\sigma}.$$

Lemma 2 *We have* $e_C\geq\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1}{1-\sigma}}e_{NM}$.

Proof. We need to show that $\vartheta\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{1-(1-\mu)\sigma}\geq 1$. Define $h\left(\vartheta\right)=ln\left(\vartheta\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{1-(1-\mu)\sigma}\right)$. As $h\left(1\right)=0$, it is sufficient to show that $h\left(.\right)$ is decreasing in ϑ for all $\vartheta<1$. But

$$h'\left(\vartheta\right)=\frac{1}{\vartheta}-\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}=\frac{\vartheta-(1-\mu)\sigma-\vartheta+\vartheta(1-\mu)\sigma}{\vartheta\left(\vartheta-(1-\mu)\sigma\right)}=-\frac{(1-\vartheta)(1-\mu)\sigma}{\vartheta\left(\vartheta-(1-\mu)\sigma\right)}<0.$$

■ Similarly,

$$\begin{aligned}\left(\frac{e_{NC}}{e^{FB}}\right)^{1-\sigma} &= [\vartheta]^{\frac{1-\sigma}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1-\sigma}{1-(1-\mu)\sigma}}\left(\left(\frac{e_C}{e^{NM}}\right)^{1-\sigma}\right)^{\frac{\mu\sigma}{1-(1-\mu)\sigma}}\\ &= [\vartheta]^{\frac{1-\sigma}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\right)^{\frac{1-\sigma}{1-(1-\mu)\sigma}}\left(\frac{\nu_H}{\nu_L}\vartheta\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{1-(1-\mu)\sigma}\right)^{\frac{\mu\sigma}{1-(1-\mu)\sigma}}\\ &= \frac{\nu_H}{\nu_L}\vartheta\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu\sigma}.\end{aligned}$$

Hence,

$$\left(\frac{e_{NC}}{e_C}\right)^{1-\sigma}=\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu\sigma-1+(1-\mu)\sigma}=\left(\frac{\vartheta-(1-\mu)\sigma}{1-(1-\mu)\sigma}\right)^{1-\sigma}. \tag{72}$$

Lemma 3 *We have* $e_{NC}<e_C$.

Proof. Obvious from (72). ■

Lemma 4 *We have* $e_{NC}<e_{FB}$.

Proof. Note that

$$\begin{aligned}\frac{e_{NC}}{e^{PC}} &= \frac{e_{NC}}{e_C}\frac{e_C}{e^{PC}}\\ &= \frac{\vartheta\left(n,\mu\right)-(1-\mu)\sigma}{1-(1-\mu)\sigma}\vartheta\left(n,\mu\right)^{\frac{1}{1-\sigma}}\left(\frac{1-(1-\mu)\sigma}{\vartheta\left(n,\mu\right)-(1-\mu)\sigma}\right)^{\frac{1-(1-\mu)\sigma}{1-\sigma}}\\ &= \vartheta\left(n,\mu\right)^{\frac{1}{1-\sigma}}\left(\frac{1-(1-\mu)\sigma}{\vartheta\left(n,\mu\right)-(1-\mu)\sigma}\right)^{\frac{1-(1-\mu)\sigma-1+\sigma}{1-\sigma}}\\ &= \left[\vartheta\left(n,\mu\right)\left(\frac{1-(1-\mu)\sigma}{\vartheta\left(n,\mu\right)-(1-\mu)\sigma}\right)^{\mu\sigma}\right]^{\frac{1}{1-\sigma}}.\end{aligned}$$

Note that the term in brackets is increasing as

$$\begin{aligned}\frac{\partial ln\left[\vartheta\left(n,\mu\right)\left(\frac{1}{\vartheta(n,\mu)-(1-\mu)\sigma}\right)^{\mu\sigma}\right]}{\partial\vartheta} &= \frac{1}{\vartheta}-\frac{\mu\sigma}{\vartheta-\left(1-\mu\right)\sigma}\\ &= \frac{\vartheta-\left(1-\mu\right)\sigma-\mu\sigma\vartheta}{\vartheta\left(\vartheta-\left(1-\mu\right)\sigma\right)}\\ &= \frac{\vartheta-\sigma+\sigma\mu\left(1-\vartheta\right)}{\vartheta\left(\vartheta-\left(1-\mu\right)\sigma\right)}.\end{aligned}$$

Hence,

$$\vartheta\left(n,\mu\right)\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta\left(n,\mu\right)-\left(1-\mu\right)\sigma}\right)^{\mu\sigma}\leq 1\left(\frac{1-\left(1-\mu\right)\sigma}{1-\left(1-\mu\right)\sigma}\right)^{\mu\sigma}=1.$$

■ Total profits are then given by

$$\begin{aligned}\pi\left(n\right) &= \frac{\gamma-1}{\gamma}\left(e_{NC}^{1-\mu}e_{C}^{\mu}\right)^{\sigma}Q\left(t\right)n\\ &= \left(\frac{e_{NC}^{1-\mu}e_{C}^{\mu}}{e_{FB}}\right)^{\sigma}\pi^{FB}\left(n\right)\\ &= \left(\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta-\left(1-\mu\right)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}}\pi^{FB}\left(n\right).\end{aligned}\tag{73}$$

where

Lemma 5 *We have* $\pi\left(n\right)<\pi^{FB}$.

Proof. It is easy to show that $\frac{\partial ln\left(\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu}\vartheta\right)}{\partial\vartheta}=\frac{(1-\mu)(\vartheta-\sigma)}{\vartheta(\vartheta-(1-\mu)\sigma)}>0$. Hence, $1=\arg\max_{\vartheta}\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu}\vartheta$ so that $\left(\frac{1-(1-\mu)\sigma}{\vartheta-(1-\mu)\sigma}\right)^{\mu}\vartheta\leq 1$. ■

Finally, we need to characterize $V\left(n\right)$. From (62) and (73) we get that

$$\begin{aligned}V^{F}\left(n\right) &= \left[\left(1-\sigma\right)\vartheta+\left[1-\frac{\sigma\mu}{\left(1-\left(1-\mu\right)\sigma\right)\left(1-\eta\right)}\right]\left(1-\vartheta\right)\right]\pi-\kappa Q\left(t\right)\\ &= \left[\left(1-\sigma\right)\vartheta+\left[1-\frac{\sigma\mu}{\left(1-\left(1-\mu\right)\sigma\right)\left(1-\eta\right)}\right]\left(1-\vartheta\right)\right]\left(\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta-\left(1-\mu\right)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}}\pi^{FB}\left(n\right)-\kappa Q\left(t\right).\end{aligned}$$

From (66) we have that η and ϑ are linked via

$$\eta=\frac{\left(1-\vartheta\right)}{\vartheta}\frac{\left(1-\mu\right)\sigma}{1-\left(1-\mu\right)\sigma}.$$

Substituting this, we get that[19]

$$\begin{aligned}V^{F}\left(n\right) &= \left[\left(1-\sigma\right)\vartheta+\left[1-\frac{\sigma\mu}{1-\frac{1}{\vartheta}\left(1-\mu\right)\sigma}\right]\left(1-\vartheta\right)\right]\left(\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta-\left(1-\mu\right)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}}\pi^{FB}\left(n\right)-\kappa Q\left(t\right)\\ &= \left[1-\sigma\vartheta\left(1+\frac{\mu\left(1-\vartheta\right)}{\vartheta-\left(1-\mu\right)\sigma}\right)\right]\left(\left(\frac{1-\left(1-\mu\right)\sigma}{\vartheta-\left(1-\mu\right)\sigma}\right)^{\mu}\vartheta\right)^{\frac{\sigma}{1-\sigma}}\pi^{FB}\left(n\right)-\kappa Q\left(t\right).\end{aligned}$$

[19] Note that

$$1-\eta=1-\frac{\left(1-\vartheta\right)}{\vartheta}\frac{\left(1-\mu\right)\sigma}{1-\left(1-\mu\right)\sigma}=\frac{1-\frac{1}{\vartheta}\left(1-\mu\right)\sigma}{1-\left(1-\mu\right)\sigma}.$$

Note first that $\mu = 1$ implies that

$$V^F(n)\big|_{\mu=1} = (1-\sigma)\,\pi^{FB}(n) - \kappa Q(t),$$

which is the first-best outcome.

6.6 Proof of Proposition 3

To show that $\vartheta^C(n,\mu)$ is increasing in μ, define

$$h(\vartheta,\mu) = \left(\frac{1-(1-\mu)\sigma}{\vartheta^C(n,\mu)-(1-\mu)\sigma}\right)^{1-\sigma(1-\mu)}\vartheta^C(n,\mu).$$

As $\partial_\vartheta h > 0$, $\vartheta^C(n,\mu)$ is increasing in μ if $\partial_\mu h < 0$. Let us define $r = 1-\sigma(1-\mu)$. We then need to show that

$$\frac{\partial}{\partial r}\left[ln\left(\frac{r}{\vartheta^C(n,\mu)-1+r}\right)^r\right] = \frac{\partial r\left[ln(r)-ln(r-(1-\vartheta))\right]}{\partial r} < 0.$$

But

$$\begin{aligned}\frac{\partial r\left[ln(r)-ln(r-(1-\vartheta))\right]}{\partial r} &= \left[ln(r)-ln(r-(1-\vartheta))\right] + r\left(\frac{1}{r}-\frac{1}{r-(1-\vartheta)}\right)\\ &= -\left[\left(\frac{r}{r-(1-\vartheta)}-1\right)-ln\left(\frac{r}{r-(1-\vartheta)}\right)\right]\\ &< 0,\end{aligned}$$

as $\frac{r}{r-(1-\vartheta)} = x > 1$, and $x-1 > ln(x)$ for $x > 1$.