"Risk Markups"

Abstract

Optimal policy in an economy with misallocation depends on the origin of markups. We develop a model of heterogeneous markups generated by uninsurable persistent idiosyncratic risk. Entrepreneurs hire labor trading off expected profits against risk. Markups arise as compensation for risk and create misallocation. We microfound incomplete risk sharing with moral hazard and hidden trade. The constrained-efficient allocation can be implemented with a uniform labor subsidy (or tax) and does not affect TFP. The subsidy equals the product of (1) the aggregate markup and (2) workers' consumption share divided by their Pareto weight. It is uniform because targeted subsidies can be exploited by entrepreneurs' hidden actions—the boundary of the firm is not invariant to policy. The markup component reflects inefficient risk premia and the consumption-share component reflects inefficient precautionary saving. In the long-run the optimal policy is a tax with a take-home rate equal to workers' consumption divided by labor income.