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Taxation, Innovation, and Entrepreneurship

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# Taxation, Innovation, and Entrepreneurship\*

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## Abstract

We explore optimal and politically feasible growth policies in the form of basic research investments and taxation. Basic research is a public good that benefits innovating entrepreneurs, but its provision and financing also affect the entire economy – in particular, occupational choices of potential entrepreneurs, wages, dividends, and aggregate output. We show that the impact of basic research on the general economy rationalizes a taxation pecking order to finance basic research. More specifically, in a society with desirably dense entrepreneurial activity, a large share of funds for basic research should be financed by labor taxation, while a minor share should be left to profit taxation. Such tax schemes will induce a significant proportion of agents to become entrepreneurs, thereby rationalizing substantial investments in basic research that fosters their innovation prospects. These entrepreneurial economies, however, may make a majority of workers worse off, giving rise to a conflict between efficiency and equality. We discuss ways of mitigating this conflict and thus strengthening the political support for growth policies.

**Keywords** basic research · economic growth · entrepreneurship · income taxation · political economy

**JEL Classification** D72 · H20 · H40 · O31 · O38

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# 1 Introduction

The contribution of innovative entrepreneurship to the well-being of societies has been a constant concern for policy-makers and is at the center of policy debates on how to induce growth in the Eurozone (Economist, 2012). In this paper on basic research and taxation, we will be examining two key drivers that shape entrepreneurial activities in societies and that are prominent in academic and policy debates.<sup>1</sup>

Basic research is a sophisticated public good. The main beneficiaries are innovating entrepreneurs: basic research improves their chances of developing new varieties or new, less cost-intensive production technologies.<sup>2</sup> At the same time, these innovating entrepreneurs are needed for basic research investments to become effective: basic research is embryonic in nature and only impacts indirectly on the economy via applied research and commercialization. In this paper we ask how much of this public good should be provided and how it should be financed. We further inquire whether optimal policies can be politically implemented.

Providing and financing basic research is an intricate task. Taxation will not only help to fund these investments, it will also impact on the entire economy through a variety of feedback effects. In particular, basic research investments and tax policies jointly impact on:

- the occupational choice of individuals to become entrepreneurs;
- wages earned by workers;
- dividends paid to shareholders by final-good producers;
- aggregate output.

We address these interdependencies in a general equilibrium framework. We develop a simple model of creative destruction where a final consumption good is produced using labor and a continuum of indivisible intermediate goods as inputs. Agents can

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<sup>1</sup>Cf. European Commission (2008), European Commission (2013), and General Secretariat of the European Council (2010), for example. With the ambition to stimulate innovation and growth, the European Union is aiming towards directing 3% of GDP to R&D by 2020, 1/3 of which is supposed to be publicly funded (basic) research. The Netherlands, for example, have strengthened tax incentives for entrepreneurship and innovation (Government of the Netherlands, 2010).

<sup>2</sup>The positive effect of basic research on applied research has been the subject of several studies (cf. Gersbach et al. (2010) for a discussion of the literature). Link and Rees (1990) and Acs et al. (1994) provide evidence suggesting that small firms may benefit particularly strongly from university R&D.

either work in the final-goods sector, in the intermediate-goods sector, or they can become entrepreneurs or basic researchers. Entrepreneurs can benefit from basic research provided by the government and invest in applied research to develop labor-saving technologies for intermediates. Successful entrepreneurs will earn monopoly profits. In addition, entrepreneurship has immaterial costs (such as entrepreneurial effort cost) and benefits (such as initiative and social status). Potential entrepreneurs weigh these costs and benefits against the labor income lost when deciding on whether or not to become entrepreneurs. The government finances its basic research investments using a combination of labor income, profit, and (potentially) lump-sum taxes. This financing decision also affects the occupational choice made by potential entrepreneurs and hence impacts on the effectiveness of basic research investments.

### *Results and implications*

Our first main insight is that financing basic research – a public good that impacts the economy indirectly through various channels – rationalizes a taxation pecking order. In particular, when innovations can potentially lead to labor savings that exceed labor used for entrepreneurial activities and basic research, it is desirable to have an innovative economy with dense entrepreneurial activities and basic research (called an *entrepreneurial economy*). In an entrepreneurial economy, a large share of funds for basic research should be financed by labor income taxation, while a minor share should be left to profit taxation. The fact that tax rates on one source of income (here labor) are higher than tax rates on another source (here profits) is called a *taxation pecking order*. The pecking order – primarily reliant on labor income taxes – ultimately arises from the complementarity of basic research investments and tax policies: the taxation pecking order induces a significant share of agents to become entrepreneurs, thereby increasing the benefits from investments in basic research.

However, labor-saving innovations lead to declining real wages so optimal policies in an entrepreneurial economy will harm workers with little shareholdings. These distributional effects can give rise to a conflict between efficiency and equality that will undermine political support for growth policies. To examine this conflict, we assume a political economy perspective and analyze growth policies in a median voter framework. We show that if shareholdings are skewed to the right the median voter may reject any growth-stimulating entrepreneurial policies. Then the society is ‘trapped’ in a *stagnant economy*. Furthermore, even if the median voter supports a growth-

stimulating entrepreneurial economy, her preferred basic research investments and tax policy will both still be inefficient vis-à-vis the social optimum. Basic research investments tend to be too low, thus providing a rationale for the surprisingly high rates of return to public investments in (basic) research typically found in empirical studies.<sup>3</sup> Interestingly, these inefficiencies are mitigated as upper bounds on taxation increase. Then tax incentives to entrepreneurs (efficiency) and the redistribution of gains from innovation (equality) can be better aligned. Larger upper bounds on taxation allow for more redistribution to the median voter, thus potentially satisfying equity concerns and making growth policies politically feasible. At the same time, larger upper bounds on tax rates allow more flexibility in the relationship between tax rates on labor income and profits, which is decisive for entrepreneurship and innovation and hence for efficiency concerns.

The insights above may have implications for two determinants of the boundaries of tax rates: constitutional bounds and fiscal capacity. Constitutional bounds to taxation are sometimes proposed as a means of protecting investors from excessive indirect expropriation via tax policies.<sup>4</sup> We show that while low upper tax bounds do indeed protect firm-owners if growth policies are given, they may actually harm firm-owners if these growth policies are subject to the political process. Then low upper bounds on taxation may undermine the political support for growth policies, and the society may be ‘trapped’ in a stagnant economy with little entrepreneurship and low profits. Indeed, we will argue that in a constitutional design phase behind the veil of ignorance bounds on taxation are likely to be rejected.

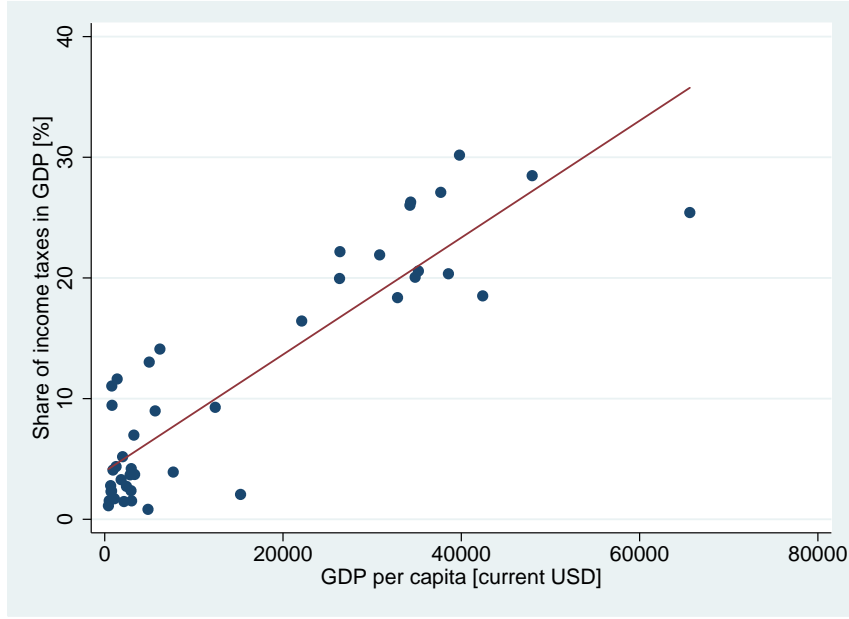
Alternatively, tax bounds may implicitly arise from fiscal capacity, ‘*economic institutions inherited from the past*’ (Besley and Persson, 2009, p. 1219) that determine the government’s ability to collect taxes. Figure 1 plots fiscal capacity against GDP per capita for a cross-section of countries, where following Besley and Persson (2009) we

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<sup>3</sup>Cf. Salter and Martin (2001) for an overview of such studies and Toole (2012) for a more recent example.

<sup>4</sup>The Swiss constitution, for example, introduces restrictive bounds on direct taxes at the federal level: ‘*The Confederation may levy a direct tax: a. of a maximum of 11.5 per cent on the income of private individuals; b. of a maximum of 8.5 per cent of the net profit of legal entities*’ (Article 128.1, Federal Constitution of the Swiss Confederation). Tax provisions are also repeatedly at the center of constitutional court rulings, and in many countries there are at least implicit tax bounds. The French constitutional court, for example, has stated that a total tax burden of 90.5% would not be admissible (cf. Conseil Constitutionnel de la République Française, 2013). Supermajority rules for tax increases are an alternative to bounds on tax rates. Several US states, for example, have such provisions, and they have also been proposed at the federal level in the past (cf., for example, National Conference of State Legislatures, 2010; Gradstein, 1999).

Figure 1: Fiscal capacity and GDP per capita



Section 7 concludes. We provide several robustness checks for our pecking order result and some additional details on the political economy of financing basic research in the appendix. Also, all the proofs are to be found in the appendix.

## 2 Literature

Our paper is related to several important strands in the literature.

### *Rationale for public funding of basic research*

The case for the public funding of basic research is well established in the literature, at least since the seminal paper of Nelson (1959). He identifies fundamental conflicts between providing basic research and the interests of profit-making firms in a competitive economy. First, the provision of basic research has significant positive external effects that cannot be internalized by private firms. Basic research should not be directed toward particular technologies, and the resulting scientific knowledge typically has practical value in many fields. As a consequence, technological specialization and a lack of patentability frequently prevent private firms from exploiting all the potential benefits from undirected basic research. Additionally, Nelson argues that due to its non-rivalry, full and free dissemination of scientific knowledge would be socially desirable. Second, Nelson argues that the long lag between basic research and its reflection in marketable products may prevent short-sighted firms from investing. Thirdly, he points out that the high uncertainty involved in the process may induce private provision of basic research below the socially optimal level. The more basic the research is the more severe these three problems become, so they represent a special motivation for the public provision of basic research.

The case for publicly funded basic research has further been substantiated by several other authors. In terms of market failure, Arrow (1962), for example, points out that invention, which he defines as the production of knowledge, is prone to three classical pitfalls: indivisibility, inappropriability, and uncertainty. Much like Nelson (1959), he argues that these problems result in underinvestment in research on the free market and that this problem is the more severe, the more basic the research is. Kay and Smith (1985) stress the enormous benefits from basic research and argue that public provision is necessary due to the public-good nature of basic research. They also out a case for the domestic provision of basic research rather than free-riding on basic

research performed by other countries.

In summary, there is a strong case for publicly funded research, in particular basic research. This rationale is borne out by the empirical evidence. Gersbach et al. (2013) report data showing that for a selection of 15 countries the average share of basic research performed in the government and higher-education sector was approximately 75% in 2009. The OECD research and development statistics tell us that across OECD member countries around 80% of total research performed in the government or higher-education sector is also funded by the government.<sup>6</sup> Taken together, these findings suggest that a major share of basic research investments are indeed publicly funded. This evidence is also in line with US data on the source of funds for basic research, as reported in National Science Board (2012, Table 4-3).

### *Effects of basic research and financing*

Our main question is how optimally chosen basic research expenditures should be financed. Our paper is thus related to the literature on financing productive government expenditures. In his seminal paper, Barro (1990) examines the case of productive government expenditures as a flow variable. Futagami et al. (1993) develop the case of productive government expenditures representing investments in a stock. These authors generate investment-based endogenous growth models where the individual firm faces constant returns to scale with respect to both private capital and the public services provided by the government. According to the comprehensive survey by Irmen and Kuehnel (2009), this applies more generally to the main body of the literature on productive government expenditures and economic growth. By contrast, our model is rooted in the tradition of R&D-based endogenous growth models, notably those that explicitly take into account the hierarchical order of basic and applied research (see, for example, Arnold, 1997; Morales, 2004; Gersbach et al., 2010). In these models, basic research has no productive use in itself but rather fuels into the productivity of the applied research sector, where knowledge is transformed into blueprints for new or improved products. In our case, basic research affects the innovation probability of entrepreneurs engaging in applied research. Using more public funds for basic re-

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<sup>6</sup>The data was downloaded from OECD (2012b) in April 2014 and refers to centered 5-year moving averages for 2007. For each country, the share of public funding in the government and higher-education sector has been computed as follows: 
$$\frac{\text{sub-total government funding in higher-education sector} + \text{sub-total government funding in government sector}}{\text{total funding higher-education sector} + \text{total funding government sector}}.$$
 The average of these shares across all OECD member countries works out at slightly below 80%.

search improves the chances of success for private entrepreneurs at the cost of diverting resources away from intermediate- and final-good production.

This implies that financing basic research has to fulfill a second important role. Suppose basic research is financed via a combination of labor income, profit, and lump-sum taxes. The relative size of labor to profit taxes affects the trade-off faced by potential entrepreneurs between being employed in the labor market and becoming an entrepreneur. Hence it influences the number of innovating entrepreneurs in our economy. To sum up, a socially efficient financing scheme for basic research must simultaneously provide the funds for these investments and must induce a socially desirable share of agents to become entrepreneurs.

### *Optimal taxation in an economy with entrepreneurship*

We want to analyze the optimal mix of basic research and tax policies. Accordingly, our paper is also related to the literature on optimal income taxation in the tradition of Mirrlees (1971). At the heart of our model is the occupational choice by (potential) entrepreneurs. Boadway et al. (1991) present a model with heterogeneous agents who can choose between becoming entrepreneurs or workers. While they restrict tax rates to make them the same for both types of labor, in our model the government can distinguish between taxes on profits and taxes on labor income.<sup>7</sup> Kanbur (1981) considers a model with an endogenous occupational choice on the part of homogeneous agents between becoming a worker earning a safe wage and an entrepreneur earning risky profits. While he considers entrepreneurial risk-taking under occupation-dependent taxation, he does not derive optimal tax policies. In this regard, his work is close in nature to calibrated dynamic general equilibrium models used to assess the effects of stylized tax reforms (see, for example, Meh, 2005; Cagetti and De Nardi, 2009).

Moresi (1998) and Scheuer (2013) analyze optimal tax policies in models of asymmetric information with occupational choice, where the government faces a trade-off between efficiency and equality.<sup>8</sup> The distinctive feature of our model is that we analyze optimal

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<sup>7</sup>Allen (1982) had previously presented a model with two types of workers, skilled and unskilled, who can choose between two types of labor. In his model, however, workers perfectly select into these types of labor on the basis of their skill-group. In that sense, his model is closer in nature to Feldstein (1973) and Stiglitz (1982), who consider optimal taxation with two types of workers but no occupational choice. All of these papers also consider one tax instrument only.

<sup>8</sup>Haufler et al. (2012), for example, take a different viewpoint on optimal tax policies with entrepreneurship. They consider a model where entrepreneurs engage in risky innovation and endogenously choose the quality (riskiness) of their project. Gains from innovation are subject to different tax treatments, depending on whether the entrepreneur has entered the market or sold his project to

tax policies and the investment of tax revenues in basic research. This means that the government can simultaneously affect the share of entrepreneurs in an economy and their innovativeness. We show that in such circumstances efficient policies make use of a taxation pecking order. Notably, in our model investments in basic research that allow for efficiency gains in aggregate should be accompanied by low profit taxes and high labor income taxes.

### *Political economics of tax policies*

Romer (1975), Roberts (1977), and Meltzer and Richard (1981) analyze majority voting on linear income taxes. Their work is a classical benchmark suggesting that if income distribution is skewed to the right voting will result in inefficiently high tax rates.<sup>9</sup> In our model the median voter's preferred policy may not maximize aggregate output, either on the extensive or on the intensive margin. On the one hand, if bounds on taxation are too restrictive, then the median voter will prefer a stagnant economy to growth-stimulating policies, and her preferred choice is inefficient on the extensive margin. On the other hand, if the median voter prefers some kind of growth-stimulating entrepreneurial economy, then her policy choice is inefficient on the intensive margin. The voter will generally prefer to have profit taxes that are too high and basic research investments that are too low vis-à-vis the social optimum.

Persson and Tabellini (1994) and Alesina and Rodrik (1994) were among the first to assess the implications of these inefficiencies for long-run economic growth by incorporating politico-economic equilibria into endogenous growth models. According to their models, increased inequality compromises long-run growth perspectives via stronger redistributive taxation. Both papers present empirical evidence supporting this main finding. We consider an R&D-based growth model as opposed to an investment-based growth model. As in Alesina and Rodrik (1994), the government can engage in productive government expenditures which, however, only affect the economy indirectly via innovating entrepreneurs. We show that in our model greater inequality also hinders growth-stimulating policies. However, this conflict of interests between growth policies and redistribution can be resolved if (constitutional) tax bounds are sufficiently

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an incumbent. Optimal tax policies then trade off the gains from increased competition via market-entry against the losses of reduced entrepreneurial risk-taking due to lost tax deductions in the case of failure.

<sup>9</sup>Cf. Persson and Tabellini (2002) for a discussion and Traxler (2012) for a more recent example from the related literature.

flexible. The intuition is that tax policies impact indirectly on economic growth via the occupational choice of potential entrepreneurs, which is shaped by relative, rather than by absolute tax rates.

Given that (constitutional) tax bounds are center stage in our political economy section, our work also relates to the literature on constitutional design for tax policies. In their pioneering work in this area, Brennan and Buchanan (1977) assume that constitutional design takes place behind a veil of ignorance about future income. The constitutional limits on taxation should optimally be designed as an obstacle for a Leviathan-type government that maximizes revenues within these limits. As we show, constitutional tax bounds that are too small can prevent growth-stimulating policies from being supported by the median voter. Under certain conditions, this implies that households will reject any tax bound when voting behind the veil of ignorance in a constitutional design phase.

An alternative view on the bounds of taxation operative in our model is to interpret them as a reduced form for state capacity in the spirit of Acemoglu (2005) and Besley and Persson (2009). While, in the latter, fiscal capacity affects growth indirectly via its complementarity with other state capacities, in the former fiscal capacity directly influences growth as a determinant of the extent of distortionary taxation and productive investments by self-interested governments. We provide an alternative political economy rationale explaining why fiscal capacities may fundamentally affect growth: weak fiscal capacities do not allow for sufficient redistribution of gains from innovation and hence undermine political support for it.

### 3 The model

The economy is populated by a continuum of measure  $\bar{L} > 1$  of households deriving utility  $u(c) = c$  from a final consumption good. Each household either inelastically supplies one unit of homogeneous labor or chooses to become an entrepreneur, as shown below. Households are indexed by  $k$  ( $k \in [0, \bar{L}]$ ).

### 3.1 Production

The final good,  $y$ , is produced with a continuum of intermediate goods  $x(i)$  ( $i \in [0, 1]$ ). The production technology is given by:

$$y = L_y^{1-\alpha} \int_0^1 x(i)^\alpha di, \quad (1)$$

where  $L_y$  denotes the labor employed in final-good production and where  $0 < \alpha < 1$ . The final good is only used for consumption, hence in equilibrium the output of the final good equals aggregate consumption  $C$ , i.e.  $C = y$ .

We assume that intermediate goods  $x$  are indivisible, i.e.  $x(i)$  is either 1 or 0.<sup>10</sup> The final good is chosen as the numéraire with its price normalized to 1. Firms in the final-good sector operate under perfect competition. They take the price  $p(i)$  of intermediate goods as given. In the following, we work with a representative final-good firm maximizing its profits  $\pi_y$ :

$$\pi_y = y - \int_0^1 p(i)x(i) di - wL_y \quad (2)$$

by choosing the quantities  $x(i) \in \{0, 1\}$  and the amount of labor  $L_y$ . The variable  $w$  denotes the wage prevailing in the market for labor. If the final-good producer chooses  $x(i) = 1$  for all  $i$ , the demand for labor in final-good production will be:

$$L_y = \left( \frac{1-\alpha}{w} \right)^{\frac{1}{\alpha}}. \quad (3)$$

### 3.2 Behavior of intermediate-good producers

Each intermediate good can be produced by a given standard technology using  $m > 0$  units of labor. Hence, marginal production costs when using the standard technology

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<sup>10</sup>As we explain later, we consider the case of labor-saving technological progress in the intermediate-good sector. With indivisible intermediate goods, labor saved in intermediates production is not taken up elsewhere in the economy at constant wages. This can give rise to a stark conflict of interest between equality and efficiency and hence to political conflicts in our economy. We discuss these in detail in section 6. Three remarks are in order at this stage: first, our finding of the optimality of a taxation pecking order relies neither on labor-saving technological innovation nor on the indivisibility of intermediates. It follows rather from the complementarity of basic research and the occupational choice of potential entrepreneurs. Second, we believe that the conflict between equality and efficiency in our economy is broadly in line with the decreasing shares of labor income in aggregate income, in particular for low-skilled labor, that can be observed in the EU and the US (cf. footnote 31). And third, while the indivisibility of intermediates can accentuate the equality-efficiency trade-off in our economy, it is not necessary for such effects to arise (cf. footnote 32).

are  $mw$ . We assume that the standard technology is freely available. If an entrepreneur engages in research and development and successfully innovates, the labor input per unit of the intermediate declines by a factor  $\gamma$  ( $\gamma < 1$ ), leading to marginal production costs of  $\gamma mw$ . The innovating entrepreneur obtains a monopoly and offers his product at a price equal to the marginal cost of potential competitors,  $mw$ , thereby gaining profit  $\pi_{xm} = (1 - \gamma)mw$ . If no innovation takes place, Bertrand competition yields an equilibrium price of  $mw$  as well, implying zero profits for all producers of the intermediate good under consideration.

### 3.3 Innovation

There is a measure 1 of individuals  $[0, 1] \subset [0, \bar{L}]$  who are potential entrepreneurs. Individuals face different costs and benefits when deciding to become an entrepreneur. Specifically, we assume that agents are ordered in  $[0, 1]$  according to their immaterial utilities from entrepreneurial activities and where individual  $k$  faces the utility factor  $\lambda_k = (1 - k)b$  ( $k \in [0, 1]$ ,  $b$  being a positive parameter). This factor rescales the profit earned from entrepreneurial activities to take into account immaterial costs (such as cost from exerting effort as an entrepreneur or utility cost from entrepreneurial risk-taking that are not reflected in the utility from consumption) and immaterial benefits (such as excitement, initiative, or social status) associated with entrepreneurial activity.<sup>11,12</sup> Agents with a higher index  $k$  have lower utility factors. A utility factor  $\lambda_k < 1$  represents net immaterial cost of being an entrepreneur, while factor  $\lambda_k > 1$  represents net immaterial benefits.<sup>13</sup> For individuals  $k$  with  $\lambda_k = 1$ , and thus  $k^{crit} = \max\{1 - \frac{1}{b}, 0\}$ , immaterial costs and benefits associated with entrepreneurial activities cancel out. If  $b$  is small and hence  $k^{crit}$  is small or even zero, the society is characterized by a population of potential entrepreneurs for whom effort costs matter most. If  $b$  is large and hence  $k^{crit}$  is large, the potential entrepreneurs enjoy being one compared to a worker. We assume that  $\lambda_k$  is private information and hence only observed by agent

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<sup>11</sup>We use a multiplicative rather than an additive form to capture costs and benefits from entrepreneurship. A detailed rationale will be provided in footnote 22.

<sup>12</sup>Cf. footnote 23 for a discussion on how differences in risk-attitudes may give rise to occupational choice effects similar to the ones arising from our immaterial benefit factor  $\lambda_k$ .

<sup>13</sup>Our concept of immaterial utilities associated with being an entrepreneur is in line with empirical evidence (cf. Douglas and Shepherd, 2000; Hamilton, 2000; Praag and Versloot, 2007; Benz and Frey, 2008; Benz, 2009; Fuchs-Schündeln, 2009). Most studies find that entrepreneurship involves positive non-monetary benefits. Fuchs-Schündeln (2009) shows that there is heterogeneity across the population in such immaterial utilities and that they may be negative for some households.

$k$ .<sup>14</sup>

The chances of entrepreneurs of successfully innovating can be fostered by basic research. Basic research generates knowledge that can be taken up by entrepreneurs and transformed into innovations that improve their production process. Specifically, suppose that the government employs  $L_B$  ( $0 \leq L_B \leq \bar{L}$ ) researchers in basic research. Then the probability that an entrepreneur will successfully innovate is given by  $\eta(L_B)$ , where  $\eta(L_B)$  fulfills  $\eta(0) \geq 0$ ,  $\eta'(\cdot) > 0$ ,  $\eta''(\cdot) < 0$  and  $\eta(\bar{L}) \leq 1$ .<sup>15</sup> Depending on whether  $\eta(0) = 0$  or  $\eta(0) > 0$ , basic research is a necessary condition for innovation or not.

Accordingly, if a measure  $L_E$  of the population decided to become entrepreneurs and the probability of success for each of them was  $\eta(L_B)$ , the share of intermediate-good industries with successful innovation would be equal to  $\eta(L_B)L_E$ .<sup>16</sup> We note that property  $L_E \leq 1$  enables entrepreneurs to perform research on a variety of the intermediate good different from others.<sup>17</sup>

### 3.4 Financing scheme

Public expenditures on basic research are financed by taxes. There are two sources of income on which the government can levy taxes: labor income or profits (in intermediate- and final-good production). We consider two scenarios involving lump-sum taxation. In our base case, we assume that the government can levy lump-sum taxes or make lump-sum transfers.<sup>18</sup> Later, we examine the case where this is not possible. A tax scheme is a vector  $(t_L, t_P, t_H)$  where  $t_L$  and  $t_P$  are the tax rates on labor income and on profits, respectively, and  $t_H$  denotes the lump-sum tax or transfer. We assume that there are upper bounds (and potentially lower bounds) for labor income and profit

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<sup>14</sup>This does preclude conditioning taxation on  $\lambda_k$ . We note that if  $\lambda_k$  is common knowledge but tax policies do not condition thereon our results will remain unaffected.

<sup>15</sup> $\eta'(\cdot)$  and  $\eta''(\cdot)$  denote the first and second derivative, respectively, of  $\eta(\cdot)$  with respect to  $L_B$ .

<sup>16</sup>We use a suitable version of the law of large numbers for a continuum of random variables.

<sup>17</sup>Strictly speaking, we assume that there is no duplication of research efforts. It is straightforward to incorporate formulations in which several researchers compete for innovation on one variety. This would decrease the benefits from basic research for entrepreneurs and for the society.

<sup>18</sup>Our model allows for unsuccessful entrepreneurs earning zero profits. Consequently, if their share of the profits of the final-good firm are not too high, they may not be able to pay the lump-sum tax. For a broad range of parameter values, lump-sum taxes are negative in optimum, implying that this is not an issue. If not, we assume that all individuals have a certain endowment that could be drawn upon by the government in this case. Moreover, we will be examining the case where lump-sum taxation is not feasible.

taxes. Upper bounds on taxation may either be specified explicitly in the constitution or they may arise implicitly from fiscal capacities in the spirit of Besley and Persson (2009), for example.<sup>19</sup> We denote the upper and lower bounds by  $\bar{t}_j$  and  $\underline{t}_j$ ,  $j \in \{L, P\}$ , respectively.<sup>20</sup> For our theoretical analysis we assume that the upper bounds are strictly smaller than 1, i.e.  $\bar{t}_j \leq 1 - \varepsilon$  for some arbitrarily small  $\varepsilon > 0$ .<sup>21</sup>

Throughout our paper, we assume that the government needs to run a balanced budget, i.e. the government budget constraint is given by:

$$wL_B = t_L(\bar{L} - L_E)w + t_P(\pi_y + \eta(L_B)L_E\pi_{xm}) + t_H\bar{L}, \quad (4)$$

where  $t_H = 0$  in the scenario without lump-sum taxes.

### 3.5 Sequence of events

We summarize the sequence of events as follows:

- (1) The government hires a number  $L_B$  of researchers to provide public basic research and chooses a financing scheme.
- (2) A share  $L_E$  of the population decide to become entrepreneurs. With probability  $\eta(L_B)$  they will successfully innovate, which enables them to capture monopoly rents. A share  $(1 - \eta(L_B))L_E$  will not be successful and will earn zero profits.
- (3) Each intermediate-good firm  $i$  hires a number  $L_x(i)$  of workers to produce the intermediate good  $x(i)$ .
- (4) The representative final-good firm buys the intermediate goods  $x(i)$  at a price  $p(i)$  and produces the homogeneous final good  $y$ .

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<sup>19</sup>Alternatively, upper bounds on tax rates may implicitly arise from harmful supply-side effects of taxation: supply effects of profit taxes are at the very heart of the analysis pursued here. Yet in an open economy, the government may also be confronted with additional harmful supply effects associated with high profit taxes that are not considered here and that may give rise to effective upper bounds on profit taxes. Similarly, supply effects of labor income taxes are only considered to the extent to which they affect the occupational choice by potential entrepreneurs. In addition, labor income taxes may affect the labor/leisure choice of workers and hence be effectively bound from above.

<sup>20</sup>Lower bounds on profit taxes, in particular, may be demanded by the international community. The European Council of Economics and Finance Ministers, for example, has agreed upon a code of conduct for business taxation that is intended to tackle harmful competition in the field of business taxation (European Union, 1998). Although this code of conduct does not explicitly define lower bounds on taxation and is not legally binding, it still represents a considerable political commitment not to have extremely low tax rates on profits.

<sup>21</sup>We choose  $\varepsilon > 0$ , as tax rates of 100 % are economically implausible and to avoid dealing with  $\tau := \frac{1-t_P}{1-t_L} = \infty$ , which will feature prominently in our subsequent analyses. Note, however, that our formal results do not depend on  $\varepsilon$  being positive.

## 4 Equilibrium for given policies

In this section we derive the equilibrium for a given amount of basic research and a given financing scheme.

### 4.1 Occupational choice by potential entrepreneurs

We first address the choice of occupation. Potential entrepreneurs, i.e. agents in the interval  $[0, 1]$ , can choose between (a) employment as workers and (b) the attempt to develop an innovation to be used in the production of intermediate goods. We are left with two cases: all agents choose to be workers or both occupations are chosen in equilibrium. If both occupations are chosen in equilibrium, the marginal entrepreneur has to be indifferent between being employed as a worker and becoming an entrepreneur. The expected net profit of an entrepreneur is:

$$\pi^E = (1 - t_P)\eta(L_B)\pi_{xm} = (1 - t_P)w\eta(L_B)m(1 - \gamma) .$$

The last expression indicates that the expected profit of the entrepreneur consists of the expected amount of labor saved in intermediate-good production:

$$\chi(L_B) := \eta(L_B)m(1 - \gamma) , \quad (5)$$

scaled by the wage rate net of profit taxes. Hence the expected utility for an individual  $k$  with (dis-)utility factor  $\lambda_k = (1 - k)b$  from being an entrepreneur is:<sup>22</sup>

$$EU^E(k) = (1 - t_P)w\chi(L_B)(1 - k)b .$$

If  $EU^E(k) = (1 - t_L)w$ , the individual is indifferent between being employed as a worker and becoming an entrepreneur. Solving for the indifferent entrepreneur's index  $k$  yields the equilibrium amount of entrepreneurs denoted by  $L_E^e$  as:<sup>23</sup>

$$L_E^e = \max \left\{ 0; 1 - \frac{1 - t_L}{1 - t_P} \frac{1}{\chi(L_B)b} \right\} . \quad (6)$$

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<sup>22</sup>Note that we have chosen a multiplicative functional form. An alternative approach is to use an additive functional form by deducting the cost (see, for example, Boadway et al., 1991; Scheuer, 2013). The multiplicative approach is more convenient and analytically much easier. In addition, it implies that the net immaterial benefit is scaled by entrepreneurial profits. The multiplicative approach may therefore be more appropriate in reflecting effort costs and social status benefits, in particular, as these would typically be related to profits. For  $\lambda_k < 1$  the effort costs dominate, while for  $\lambda_k > 1$  the social status benefits dominate. Qualitatively, however, the additive and the multiplicative approach involve the same trade-offs and pecking-order considerations.

<sup>23</sup>In our model potential entrepreneurs differ in their immaterial costs and benefits from being an entrepreneur. Agents whose expected utility from being an entrepreneur exceeds the utility from

We note that  $L_E^e$  is independent of the wage level. Higher wages are associated with higher profits from entrepreneurship and, of course, imply higher labor income. In the following we use:

$$\tau := \frac{1 - t_P}{1 - t_L} \quad (7)$$

as an abbreviation for  $\frac{1-t_P}{1-t_L}$ , with the upper and lower bounds of  $\tau$  denoted by  $\bar{\tau}$  and  $\underline{\tau}$  being defined by the respective bounds of  $t_L$  and  $t_P$ .  $\tau$  is a measure of tax incentives given to (potential) entrepreneurs.<sup>24</sup> Moreover, let  $\bar{\tau} \geq 1 \geq \underline{\tau}$ , implying that a neutral tax policy  $t_L = t_P$  is always possible.

Knowing  $L_E^e$  from (6), we obtain the amount of labor employed in the production of intermediates as:

$$L_x^e = \int_0^1 L_x(i) di = m - \chi(L_B) L_E^e, \quad (8)$$

if  $x(i) = 1 \forall i$ . This corresponds to the amount of labor necessary to produce the intermediate goods with standard technology less the (expected) amount of labor saved by the new technologies invented by the entrepreneurs.

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working in the labor market opt to become entrepreneurs, thus giving rise to continuous occupational choice effects. We note that a similar result for the occupational choice would arise if agents differed in their risk attitude rather than in an extra (dis-)utility term. Suppose, for example, that potential entrepreneurs differ only in their degree of constant relative risk-aversion with  $u_k(c) = \frac{c^{(1-r_k)}}{1-r_k}$ , where  $r_k$  is distributed according to some continuous and differentiable distribution function  $F_{r_k}(r_k)$  on  $[0, 1]$  satisfying  $\frac{dF_{r_k}(\cdot)}{dr_k} > 0, \forall r_k \in [0, 1]$ . Suppose further that insurance against entrepreneurial risks is not possible. Then individual  $k$  opts to become an entrepreneur if his certainty equivalent from being an entrepreneur is at least as large as his after-tax wage:  $[\eta(L_B)]^{\frac{1}{1-r_k}} (1 - t_P)m(1 - \gamma)w \geq (1 - t_L)w$  for the case of no other income. It follows that all potential entrepreneurs with  $r_k \leq \bar{r} = \max \left\{ 0; 1 - \frac{\ln(\eta(L_B))}{\ln(1-t_L) - \ln((1-t_P)m(1-\gamma))} \right\}$  will become entrepreneurs. The equilibrium number of entrepreneurs is then given by  $L_E = F_{r_k}(\bar{r})$ . As for the case with heterogeneous immaterial costs and benefits from being an entrepreneur, entrepreneurship is increasing in  $m$ ,  $t_L$ , and  $L_B$ , decreasing in  $t_P$  and  $\gamma$ , and independent of  $w$ . However, basic research has an additional effect here: as well as increasing the expected profit from being an entrepreneur, it affects associated entrepreneurial risks.

<sup>24</sup>Empirical evidence in the literature suggests that the tax structure does indeed influence the level of entrepreneurial activities in an economy. Using cross-sectional data from US personal income tax returns, Cullen and Gordon (2007) estimate the impact of various tax measures on entrepreneurial risk-taking as proxied by an indicator variable for whether or not an individual reports business losses greater than 10% of reported wage income. They find that a cut in personal income tax rates significantly reduces entrepreneurial risk-taking. The evidence for a cut in corporate tax rates is less clear. Depending on the model specification used, such a cut is predicted to either raise or not significantly affect entrepreneurial risk-taking. As the risk-sharing of non-diversifiable entrepreneurial risks with the government is positively related to the corporate income tax rate, Cullen and Gordon interpret their results as being in line with their theory. Djankov et al. (2010) analyze cross-country data for 85 countries. They find that higher effective tax rates paid by a hypothetical new company have a significantly adverse effect on aggregate investment and entrepreneurship. Da Rin et al. (2011) find that corporate income taxes significantly reduce firm entry in a panel of 17 European countries. Gentry and Hubbard (2000) analyze 1979 to 1992 data from the Panel Study on Income Dynamics and find that less progressive tax rates significantly increase entrepreneurship.

## 4.2 Equilibrium for given basic research and financing scheme

We will now derive the equilibrium for given basic research and the given tax policy. Due to the indivisibility of the different varieties of the intermediate goods, we have to consider the case where despite diminishing returns to intermediate goods in final-good production, the final-good firm will not use all the different varieties or may even go out of business and not produce at all. We start by considering the equilibrium in the market for intermediate goods for the case of positive production in the final-good sector:

### Lemma 1

- (i) *In any equilibrium with positive production in the final-good sector, intermediate-good producers supplying their product will charge  $p(i) = mw$ .*<sup>25</sup>
- (ii) *In any equilibrium with positive production in the final-good sector, the final-good producer will use all varieties of intermediate goods.*

The proof of Lemma 1 can be found in appendix C.1. As a consequence of point (ii) in Lemma 1, we can use the equilibrium number of entrepreneurs (6) and labor in intermediate-good production (8) together with the market clearing condition in the labor market:

$$\bar{L} = L_E^e + L_B + L_y^e + L_x^e \quad (9)$$

to derive the number of workers employed in the final-good sector in an equilibrium with positive final-good production:

$$L_y^e = \bar{L} - L_B - L_E^e - L_x^e . \quad (10)$$

Equation (3) yields the corresponding equilibrium wage rate as:

$$w^e = (1 - \alpha)(\bar{L} - L_B - L_E^e - L_x^e)^{-\alpha} . \quad (11)$$

Finally, we determine when an equilibrium with positive production will occur, that is, under what condition(s) the final-good firm will make positive profits. Using the profit function (2) and Lemma 1, we obtain equilibrium profits in the final-good sector:

$$\pi_y^e = (L_y^e)^{1-\alpha} - w^e L_y^e - w^e m .$$

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<sup>25</sup>To avoid needing to discretize the strategy space in order to obtain the existence of equilibria in the price-setting game in the intermediate-good industry  $i$ , we assume as a tie-breaking rule that the final-good producer demands the product from the innovating entrepreneur if he offers the same price as non-innovating competitors.

Inserting the equilibrium wage rate (11) yields:

$$\pi_y^e = \alpha(L_y^e)^{1-\alpha} - (1-\alpha)m(L_y^e)^{-\alpha}. \quad (12)$$

We observe that the final-good firm's profit strictly increases in the amount of labor it employs in equilibrium. This is very intuitive, as higher employment in final-good production yields higher output and this is associated with lower wages in equilibrium, implying that the prices of both the inputs labor and intermediate goods are lower. Consequently, according to (12), the final-good firm's profits will be positive if the amount of labor employed in final-good production exceeds the critical level,  $L_y^c := m\frac{1-\alpha}{\alpha}$ . By (6), (8), and (10), this will always be the case in equilibrium, if governmental policy  $(\tau, L_B)$  satisfies the following Positive Profit Condition (PPC):

$$\frac{m}{\alpha} \leq \begin{cases} \bar{L} - L_B & \text{if } \frac{1}{\tau\chi(L_B)b} \geq 1 \\ \bar{L} - L_B + \left[1 - \frac{1}{\tau\chi(L_B)b}\right] [\chi(L_B) - 1] & \text{if } \frac{1}{\tau\chi(L_B)b} < 1 \end{cases}. \quad (\text{PPC})$$

Otherwise the wage rate is too high so that the indivisible intermediate goods are too expensive to realize positive profits.<sup>26</sup> We observe that (PPC) depends only on parameters of the model and on government policy.

We are now in a position to characterize the allocation and prices in the equilibrium of the economy for given basic research investments  $L_B$  and a given financing scheme  $\tau$ .

**Proposition 1**

(i) If  $L_B$  and  $\tau$  satisfy condition (PPC), there is a unique equilibrium with  $x^e(i) = 1 \forall i$  and:

- (1)  $L_E^e = \max \left\{ 0; 1 - \frac{1}{\tau\chi(L_B)b} \right\}$
- (2)  $L_x^e = m - \chi(L_B)L_E^e$
- (3)  $L_y^e = \bar{L} - L_B - m + L_E^e [\chi(L_B) - 1]$
- (4)  $w^e = (1 - \alpha) (L_y^e)^{-\alpha}$
- (5)  $p^e(i) = m(1 - \alpha) (L_y^e)^{-\alpha} \forall i$
- (6)  $y^e = (L_y^e)^{1-\alpha}$
- (7)  $\pi_y^e = (L_y^e)^{-\alpha} (\alpha L_y^e - m(1 - \alpha))$
- (8)  $\pi_{xm}^e = (1 - \gamma)m(1 - \alpha)(L_y^e)^{-\alpha}$

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<sup>26</sup>Lemma 1 implies that the cost of intermediates are essentially a fixed cost, which is increasing in  $w^e$ . If wages are too high ( $L_y^e$  is too low), then the variable profits from operations are not large enough to compensate for these fixed costs.

- (ii) If  $L_B$  and  $\tau$  do not satisfy condition (PPC), there is a unique equilibrium with  $x^e(i) = 0 \forall i$ ,  $L_E^e = L_x^e = L_y^e = 0$ , zero output, and zero profits.

The proof of Proposition 1 can be found in appendix C.2. In the sequel we focus on case (i) of Proposition 1, in which the economic activities are viable.

## 5 Optimal policies

The government can affect the previously established equilibrium outcomes by investing in basic research and via the tax scheme. The government's objective is to maximize welfare in the economy, which comprises a material component – consumption – and an immaterial component, the entrepreneurs' (dis-)utility from being an entrepreneur. The utility from being an entrepreneur cannot be observed directly by the government. In our simple model framework, the government could determine the immaterial welfare component from the revealed occupational choices of the individuals together with the precise distribution of (dis-)utilities from being entrepreneur. As this distribution may be impossible to observe in reality, we first consider a government that concentrates on the material welfare component, that is, on aggregate consumption. We will show in appendix A.2 that our main insight regarding the taxation pecking order prevails and may be reinforced with a broader welfare measure that additionally accounts for the utility costs and benefits from becoming an entrepreneur. In order to simplify the notation, we assume in the remainder of the paper that the equilibrium of Proposition 1 is realized, and we dispose of superscript  $e$  in all expressions.

We now begin our discussion of optimal policies with some preliminary considerations before turning to the solution of the government's maximization problem.

### 5.1 Preliminary considerations

#### *Government policies and entrepreneurship*

Note that before taxes, the expected profit of an entrepreneur is higher than the wage rate in goods production if  $\chi(L_B) \geq 1$ . That is, by entrepreneurial activity, the individual saves in expectation more labor in intermediate-good production than the unit of labor he could provide the labor market with himself. However, even if entrepreneurship had a negative impact on labor supply in final-good production and hence on output

(i.e. if  $\chi(L_B) < 1$ ), individuals may find it worthwhile to become entrepreneurs due to immaterial benefits and tax policy  $\tau$ . To allow for both corner and interior solutions for entrepreneurship and output-increasing and output-decreasing entrepreneurship, we make the following assumption:

**Assumption 1**

- (i)  $\chi(0) < 1$     (ii)  $1/\bar{\tau} < b \leq 1/\chi(0)$

Assumption 1(i) states that, in expectation, entrepreneurship will reduce the labor supply for final-good production and thus final output when no basic research is provided. The second inequality in (ii) enables the government to preclude output-reducing entrepreneurship by implementing a neutral tax policy and not investing in basic research. By contrast, the first inequality in (ii) ensures that in the situation with output-increasing entrepreneurship, the government will be able to induce a positive measure of individuals to become entrepreneurs via its tax policy.

*Positive production in final-good sector*

When setting its policy  $(t_L, t_P, t_H, L_B)$ , the government has to consider the positive profit condition in the final-good sector (PPC), which determines the resulting equilibrium type. The following assumption ensures that any aggregate-consumption-optimal policy will yield an equilibrium with positive final-good production and that we can neglect (PPC) in the government's optimization problem.

**Assumption 2**

$$\bar{L} \geq \frac{m}{\alpha}$$

As we show at the beginning of the next section, the aim of the government's basic research and tax policies boils down to maximizing the amount of labor available for final-good production. As a consequence, if some feasible policy choice satisfies condition (PPC), then so does the optimal policy choice.<sup>27</sup> By Assumption 1(ii), the government can fully suppress entrepreneurship by choosing  $L_B = 0$  and  $\tau = 1$ . Assumption 2 ensures that final-good producers' profits are non-negative under this policy regime, so they will also be non-negative under the aggregate-consumption-optimal policy regime.

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<sup>27</sup>The condition (PPC) can also be interpreted as an upper bound on the wage rate. If the wage rate is too high, the inputs in final-good production become too expensive to break even with a positive amount of output.

We now derive optimal policies when lump-sum taxes or lump-sum transfers are available to the government. As the number of entrepreneurs only depends on the relation between profit and labor income taxes as captured by  $\tau$ , the assumption of lump-sum transfers enables us to separate the choice of  $L_B$  from the choice of the government's tax incentives to (potential) entrepreneurs.<sup>28</sup> If no lump-sum taxes and transfers are available, the choices of  $\tau$  and  $L_B$  cannot be separated in all cases. We discuss these issues in appendix A.1 and leave out of account such problems in the next section.

## 5.2 Optimal policy

The government's problem – maximizing material welfare – boils down to maximizing aggregate consumption,  $C$ , by choosing the amount of basic research,  $L_B$ , and the optimal ratio between profit and labor taxes,  $\tau$ , while either levying an additional lump-sum tax if labor and profit taxes satisfying optimal  $\tau$  do not suffice to finance the desired amount of  $L_B$  or making a lump-sum transfer in the case of the revenue generated by  $\tau$  being larger than required for basic research expenditures:

$$\begin{aligned} \max_{\{t_L, t_P, t_H, L_B\}} \quad & C = \pi_y + \eta(L_B)L_E\pi_{xm} + wL_y + wL_x + wL_B - (\bar{L} - L_E)wt_L \\ & - t_P[\pi_y + \eta(L_B)L_E\pi_{xm}] - t_H\bar{L} \\ \text{s.t.} \quad & wL_B = (\bar{L} - L_E)wt_L + t_P[\pi_y + \eta(L_B)L_E\pi_{xm}] + t_H\bar{L}. \end{aligned}$$

Inserting the constraint into the objective function and using the aggregate income identity  $y = \pi_y + \eta(L_B)L_E\pi_{xm} + wL_y + wL_x$  reduces the problem to:

$$\begin{aligned} \max_{\{\tau, L_B\}} \quad & C(\tau, L_B) = y(\tau, L_B) = (L_y(\tau, L_B))^{1-\alpha} \\ & = [\bar{L} - L_E(\tau, L_B) - L_B - L_x(\tau, L_B)]^{1-\alpha}. \end{aligned}$$

Hence the objective of the government is to maximize the amount of productive labor in final-good production. By inserting  $L_x$ , the objective function can be written as:

$$y(\tau, L_B) = [\bar{L} - L_B - m + L_E[\chi(L_B) - 1]]^{1-\alpha}. \quad (13)$$

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<sup>28</sup>Given that basic research investments account for a share of government expenditures only, the scenario with lump-sum taxes may also be interpreted as one where any excess funds are used to finance other government expenditures that benefit all members of the population equally. For a broad range of parameter values, lump-sum taxes are negative in optimum, i.e. we have lump-sum transfers. Then our analysis is equivalent to an analysis with no lump-sum taxes but investments in an additional public good  $g$  that can be produced by a one-to-one transformation of the consumption good and enters households' utilities as follows:  $u(c, g) = c + \frac{g}{L}$ .

Maximizing (13) is equivalent to maximizing  $\bar{L} - L_B - m + L_E[\chi(L_B) - 1]$ , which we will use in the following.

It will be useful and informative to solve the government's problem in two steps. First, we determine the optimal tax policy to finance a given amount of basic research. In the second step, we use the optimal tax policy to derive optimal basic research investments. In the first step of optimization, the Kuhn-Tucker conditions with respect to the optimal tax policy are:

$$\frac{\partial L_E}{\partial \tau}[\chi(L_B) - 1] \gtrless 0, \quad (14a)$$

$$\frac{\partial L_y}{\partial \tau}(\tau - \underline{\tau})(\tau - \bar{\tau}) = 0. \quad (14b)$$

The term in brackets on the left-hand side of (14a) expresses how much labor in intermediate-good production will be saved in expectation by an additional entrepreneur. We also observe in (14a) that the expected benefit of another entrepreneur depends on the level of basic research expenditures. For example, if  $\eta(0) \approx 0$  implying  $\chi(0) \approx 0$ , an entrepreneur is not as productive in innovating as when working in final-good production. From the definition of  $\chi(L_B)$  (see equation (5)), we observe that only if the amount of basic research is larger than  $L_{B,min} := \max\{0, \eta^{-1}(1/[m(1-\gamma)])\}$ , where  $\eta^{-1}(\cdot)$  denotes the inverse of  $\eta(\cdot)$ , will an increase in entrepreneurship be favorable for aggregate consumption.<sup>29</sup> Note that from (6)  $\frac{\partial L_E}{\partial \tau}$  is non-negative and with  $L_B \geq L_{B,min}$  strictly positive for  $\tau$  in the neighborhood of  $\bar{\tau}$  according to Assumption 1. Consequently, if  $L_B > L_{B,min}$ , the government benefits from increasing  $\tau$  to its maximum to make entrepreneurship as attractive as possible. The opposite is the case if  $L_B < L_{B,min}$ . Then the government will aim at reducing the number of entrepreneurs to a minimum by setting  $\tau$  at its lowest level.<sup>30</sup> The government's tax policy is indeterminate when  $L_B = L_{B,min}$ , and we assume that in this case it will set  $\tau = \bar{\tau}$ . Taken together, a strong version of a *taxation pecking order* is optimal where tax rates are located at opposing bounds of their respective feasible sets.

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<sup>29</sup>Note that  $L_{B,min}$  is positive by Assumption 1(i), stating that without basic research the entrepreneurs are not as productive in producing labor-saving innovations as in working in final-good production. This assumption is not necessary for our results in section 5. With  $\chi(0) \geq 1$ , the government would always choose a tax policy  $\tau = \bar{\tau}$  and basic research investments, if positive, will strictly increase the number of entrepreneurs further. This is due to the fact that by our specification of the immaterial utility component of entrepreneurship, the corner solution  $L_E = 1$  is precluded.

<sup>30</sup>Note that for  $L_B < L_{B,min}$ , there are typically multiple tax policies that entirely discourage entrepreneurship. For instance, by Assumption 1(ii), for  $L_B = 0$  the government is indifferent between any tax policies  $(t_L, t_P)$  satisfying  $\tau \in [\underline{\tau}, 1]$ . For simplicity we assume that in such cases the government will implement  $\underline{\tau}$ , i.e.  $t_L = \underline{t}_L$ ,  $t_P = \bar{t}_P$ .

We summarize our findings in the next proposition.

**Proposition 2 (Taxation Pecking Order)**

For a given amount of basic research,  $L_B$ , the government levies taxes according to:

$$\tau = \begin{cases} \bar{\tau} & \text{if } L_B \geq L_{B,min} \\ \underline{\tau} & \text{if } L_B < L_{B,min} \end{cases} . \quad (15)$$

We now determine the optimal basic research investments in the second step of the government's optimization problem. Given Proposition 2, we can split the maximization problem at the second step into one where  $L_B$  is constrained on  $L_B \geq L_{B,min}$  and another for  $L_B < L_{B,min}$ . The first problem is:

$$\begin{aligned} \max_{\{L_B \geq L_{B,min}\}} \quad & C(\tau, L_B) = y(\tau, L_B) \\ \text{s.t.} \quad & \tau = \bar{\tau} , \end{aligned}$$

which yields the necessary conditions for a maximum:

$$\frac{\partial L_E(L_B, \bar{\tau})}{\partial L_B} [\chi(L_B) - 1] + L_E(L_B, \bar{\tau}) \chi'(L_B) - 1 \leq 0 , \quad (16a)$$

$$\frac{\partial L_y(L_B, \bar{\tau})}{\partial L_B} (L_B - L_{B,min}) = 0 . \quad (16b)$$

Marginally increasing basic research investments has three different effects on final-good production. First, it improves the innovation prospects of the pool of entrepreneurs as reflected by the second term in equation (16a). Second, the increase in innovation prospects attracts additional entrepreneurs as reflected in the first term of equation (16a). Note that since  $L_B \geq L_{B,min}$  (and hence  $\chi(L_B) \geq 1$ ), this rise in entrepreneurship increases final-good production. The optimal choice of  $L_B$  trades off these gains from investments in basic research against the loss of the marginal unit of labor used in basic research rather than in final-good production, which is the third effect. This marginal labor cost of basic research is reflected by the last term  $-1$  in equation (16a). We use  $\tilde{L}_B(\bar{\tau})$  to denote the solution of this constrained maximization problem. Note that if  $\tilde{L}_B(\bar{\tau}) > L_{B,min}$ , it will satisfy (16a) with equality.

With respect to the maximization problem constrained by  $L_B < L_{B,min}$  with associated tax policy  $\tau = \underline{\tau}$ , we can directly infer that the solution will be  $\tilde{L}_B(\underline{\tau}) = 0$ . The reason is that basic research affects consumption only by improving the success probabilities of entrepreneurs. However, for all  $L_B < L_{B,min}$ , entrepreneurship will negatively affect

final output and by Assumption 1 the government will be able to deter such inefficient entrepreneurship by not providing basic research.

Overall, the government decides between implementing the policies  $(\tilde{L}_B(\bar{\tau}), \bar{\tau})$  or  $(0, \underline{\tau})$ . In the first situation, with positive basic research and entrepreneurship, we speak of an *entrepreneurial economy*. The second situation without basic research investments and entrepreneurship is called a *stagnant economy*. The government will implement the policy with positive basic research investments and a tax policy favoring entrepreneurship if and only if this will lead to higher labor supply in final-good production and hence higher consumption vis-à-vis the stagnant economy. In the stagnant economy, labor supply for final-good production is given by  $L_y = \bar{L} - m$ . Hence we observe from Proposition 1 (equations (1) and (3)) that the government will opt for the entrepreneurial economy if and only if it satisfies the following Positive Labor Savings (PLS) condition:

$$-\tilde{L}_B(\bar{\tau}) + \left[ 1 - \frac{1}{\bar{\tau}b\chi(\tilde{L}_B(\bar{\tau}))} \right] \left[ \chi(\tilde{L}_B(\bar{\tau})) - 1 \right] \geq 0. \quad (\text{PLS})$$

We summarize the optimal policy schemes as follows:

### Proposition 3

Suppose the government maximizes aggregate consumption using  $(t_L, t_P, t_H, L_B)$  as policy instruments. Then:

- (i) If and only if condition (PLS) is satisfied, there will be an entrepreneurial economy with  $\tau^* = \bar{\tau}$ ,  $L_B^* = \tilde{L}_B(\bar{\tau})$  and  $L_E = 1 - \frac{1}{\bar{\tau}b\chi(\tilde{L}_B(\bar{\tau}))}$ .
- (ii) Otherwise, there will be a stagnant economy with  $\tau^* = \underline{\tau}$ ,  $L_B^* = 0$  and  $L_E = 0$ .

We next analyze condition (PLS) more closely in order to deduce when an entrepreneurial economy is likely to be optimal.

### Corollary 1

Suppose the government maximizes aggregate consumption using  $(t_L, t_P, t_H, L_B)$  as policy instruments. Then the higher  $m$ ,  $b$ , and  $\bar{\tau}$ , and the lower  $\gamma$ , the more likely it is that an entrepreneurial economy will be optimal.

The proof of Corollary 1 is given in appendix C.3. Corollary 1 implies that the more valuable innovations are, i.e. the higher  $m$  is and the lower  $\gamma$  is, the more likely it is that we will observe an entrepreneurial economy. Further, an entrepreneurial economy

is more likely, the higher the maximum admissible level of  $\tau$ ,  $\bar{\tau}$ , is and the higher the utility benefits (the lower the utility costs) derived from becoming an entrepreneur will be, i.e. the higher  $b$  is. Intuitively, the higher  $\bar{\tau}$  and  $b$  are, the higher the number of entrepreneurs will be who are willing to take up knowledge from basic research investments in the entrepreneurial economy and hence the more attractive entrepreneurial policies will be.

Note that with lump-sum taxes, separating the choice of  $L_B$  from that of the ratio between labor and profit taxes as captured in  $\tau$  was feasible. In appendix A.1 we show that the pecking order result also holds when lump-sum taxes or transfers are not available.

## 6 The political economy of financing basic research

So far we have adopted the viewpoint of a government that seeks to maximize aggregate consumption and does not care about distributional effects. Our analyses of the previous sections suggest that innovation-stimulating investments in basic research should be complemented by a taxation pecking order. However, such innovation policies may have substantial distributional effects, in particular when there is inequality in the shareholdings of the final-good producer. Since basic research investments support labor-saving technological progress in the intermediate-good sector, labor is set free in the intermediate-good sector and additionally supplied to final-good production. This increases output and the profits of the representative final-good producer, but it also lowers wages.<sup>31,32</sup> Then, as we will see below, a share of individuals is worse off under

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<sup>31</sup>These implications are consistent with the common trend across industrialized economies that labor income – in particular labor income of low-skilled workers – as a share of total value added is decreasing over time. Timmer et al. (2010), for example, show that in the European Union the workers' share in total value added decreased from 72.1% in 1980 to 66.2% in 2005. In the US this share decreased from 66.8% to 63.2%. At the same time, the share of high-skilled workers' income in total value added increases rapidly over time. In the EU, this share increased from 8.3% in 1980 to 16.0% in 2005, while in the US it increased from 18.5% to 30.4%.

<sup>32</sup>With divisible intermediate goods, labor-saving technological progress in the intermediate-good sector would not result in a decrease in wages. Still, there would be a conflict between efficiency and equality in our economy as discussed here, at least if innovations are non-drastic as in Acemoglu et al. (2006): with divisible intermediates, an innovating entrepreneur would preferably charge a price  $p(i) = \frac{mw\gamma}{\alpha}$ . For  $\gamma > \alpha$  this is not feasible due to competition from standard technology, and the innovative entrepreneur sets price  $p(i) = mw$  instead. In that sense innovations are *non-drastic*.  $p(i) = mw \forall i$ , implies that  $w = [1 - \alpha]^{(1-\alpha)} \left[\frac{\alpha}{m}\right]^\alpha$  and hence the wage rate is independent of innovation step  $\gamma$  in the economy. Intuitively, wages depend on the marginal product of labor in final-good production and hence on the ratio of labor to intermediates used in production. With

an entrepreneurial policy vis-à-vis a stagnant economy. Hence, while ownership in the final-good firm is irrelevant for consumption-maximizing policies, it is crucial for the distributional effects of such policies. It is therefore by no means obvious that a change to an entrepreneurial policy will be supported politically. In this section we explore these distributional effects and indicate when policies fostering entrepreneurship are politically viable.

In our political economy analysis, we focus on a politically decisive individual whom we refer to as the median voter and ask whether the median voter's preferred policy will be an entrepreneurial policy or a stagnant policy. We assume that the median voter is an employee (i.e. a worker in final or intermediate-good production or a basic researcher) with a fraction  $s \geq 0$  of the per-capita shares in the final-good producer's profits.<sup>33</sup> Consequently, her after tax income is:

$$I = (1 - t_L)w + (1 - t_P)s \frac{\pi_y}{L} - t_H .$$

An entrepreneurial policy is politically viable if it is supported by the median voter. The most common interpretation is as follows: We order voters according to their shares in final-good production and interpret the decisive individual as the voter with the median amount of shares whose preferred policy will be adopted as the platform of two parties in a Downsian framework of party competition. In appendix B.1 we rationalize this interpretation within our model set-up. Due to constitutional provisions or lobbying, etc., the decisive individual may differ from the individual with the median amount of shares. Our political economy analysis is flexible enough to accommodate such settings by adjusting the shareholdings of the decisive individual,  $s$ , accordingly.

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constant intermediate-good prices, this is the same irrespective of the production technology in the intermediate-good sector. The monopoly distortion in the intermediate-good sector prevents the introduction of more intermediate-good-intense production processes in final-good production and hence a higher marginal product of labor. Note that with constant gross wages, a conflict between efficiency and equality follows from tax policies. In the entrepreneurial economy, workers contribute to the provision of basic research and hence end up with lower net wages than in the stagnant economy, where government spendings are zero. Obviously, with constant returns to scale and divisible intermediates, the final-good producer will earn zero profits, and benefits from innovation accrue to the successful entrepreneurs. So, in such circumstances, shareholdings in the final-good firms do not matter for the distribution of gains from innovation.

<sup>33</sup>Of course, this includes the special case where the median voter is a worker without any shares. This occurs when a fraction  $\frac{1}{2} < \mu < 1$  of the population are workers who do not own shares in the final-good producer. The situation where a majority of the population are workers who are not engaged in the stock market is in line with empirical evidence on stock market participation rates. Guiso et al. (2008), for example, establish for a selection of 12 OECD member states percentages of households that are engaged in the stock market. Even if indirect shareholdings are taken into consideration, Sweden is the only country where a majority of households is engaged in the stock market. In most countries, fewer than one-third of households hold shares.

We will now characterize the preferred policy of the median voter. In doing so, we restrict our analysis in two ways: first, we restrict attention to *growth-oriented* entrepreneurial policies, where here and below we say that an entrepreneurial policy (and the associated entrepreneurial economy) is growth-oriented if it yields an increase in final-good production vis-à-vis the stagnant economy. Second, we focus on lump-sum redistribution and leave to future research considerations regarding targeted transfers to a fraction of workers only.<sup>34</sup> To simplify the exposition we further assume common tax bounds for labor income and for profit taxes, that is, we assume  $\bar{t}_P = \bar{t}_L = \bar{t} \in [0, 1 - \varepsilon]$  and  $\underline{t}_P = \underline{t}_L = \underline{t} \in [0, 1 - \varepsilon]$  for some arbitrarily small  $\varepsilon > 0$  and  $\bar{t} \geq \underline{t}$ . Consequently,  $\tau \in [\underline{\tau}, \bar{\tau}] := \left[ \frac{1-\bar{t}}{1-\underline{t}}, \frac{1-\underline{t}}{1-\bar{t}} \right]$  and  $\bar{\tau} < \infty$ .

Of course, since relative to a stagnant economy a growth-oriented entrepreneurial policy means falling wages and increasing final-good profits, the median voter will support an entrepreneurial economy if she possesses a sufficient amount of shares in the final-good firms. The more realistic and interesting case is when income is skewed in such a way that the median voter possesses less than the per-capita claims on final-good profits. In particular, we assume that  $s \in \left[ 0, \frac{\bar{L}}{\bar{L} + (1-\gamma)m} \right)$ , which implies that the median voter's gross income,  $w + s \frac{\pi_y}{L}$ , decreases in aggregate output.<sup>35</sup> The resulting trade-off follows immediately. On the one hand wages are higher in the stagnant economy, and the median voter can maximally redistribute profits using the highest possible tax rate without considering incentives for occupational choice by potential entrepreneurs. On the other hand, the tax base is higher in a growth-oriented entrepreneurial economy, potentially allowing for higher redistributive transfers even if profit tax rates are lower. For this reason, an entrepreneurial economy may be preferred to a stagnant economy with maximal profit tax.

The trade-off faced by the median voter as described above can be captured in a convenient way by separating the two parts of the median voter's income, gross earnings

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<sup>34</sup>Analytically, we remain within the framework introduced in section 5.2. Note that without lump-sum taxes, redistribution via tax policies is no longer feasible and it turns out that a growth-oriented entrepreneurial economy is no longer supported by the median voter if shareholdings are sufficiently skewed. In particular, the median voter will always prefer the stagnant economy over the entrepreneurial economy if she owns less than a fraction  $\frac{\bar{L}}{\bar{L} + (1-\gamma)m}$  of the per-capita shares in the final-good producer. The reason is that in such case the gross income of the median voter is decreasing in aggregate output, as shown in the proof of Proposition 5. Hence she can be no better off in the growth-oriented entrepreneurial economy than in the stagnant economy with  $t_L = t_P = 0$ . Note that the condition discussed here is sufficient but not necessary for our result.

<sup>35</sup>Note that when the population is ordered according to shareholdings in the final-good sector, we must have  $s \in [0, 2)$ .

and net transfers:

$$I = (1 - t_L)w + (1 - t_P)s\frac{\pi_y}{L} - t_H = w + s\frac{\pi_y}{L} + NT, \quad (17)$$

where  $w + s\frac{\pi_y}{L}$  reflects the median voter's gross income and  $NT = -t_H - t_Lw - t_Ps\frac{\pi_y}{L}$  denotes net transfers to her. We obtain lump-sum tax,  $t_H$ , from the government's budget constraint as:

$$t_H = \frac{1}{\bar{L}} \left[ -t_Lw (\bar{L} - L_E) - t_P (\pi_y + \eta(L_B)L_E\pi_{xm}) + wL_B \right]. \quad (18)$$

One important observation is that for given basic research investments, the level of entrepreneurship and production is determined only by the ratio of tax rates,  $\tau = \frac{1-t_P}{1-t_L}$ , but not by the absolute values of tax rates. Hence the median voter's gross income is uniquely determined by the choices of  $\tau$  and  $L_B$ . The levels of the labor- and profit-tax rates only matter for the degree of redistribution, as becomes apparent when we insert the lump-sum transfers (18) into the formula for the net transfers  $NT$ .<sup>36</sup> As a consequence, we can determine the median voter's most preferred policy by the following procedure: first, we derive the optimal amount of redistribution by choosing the levels of  $t_L$  and  $t_P$  for given  $\tau$  and  $L_B$ . This will allow us to write the median voter's objective as a function of  $\tau$  and  $L_B$  and consequently to determine the median voter's most preferred levels of  $\tau$  and basic research investments  $L_B$ .

We discuss the median voter's maximization problem in detail in appendix B.2. In the first step in the optimization problem (for given  $\tau$  and  $L_B$ ), the median voter aims at setting  $t_L$  and  $t_P$  to maximize net transfers  $NT$ . In particular, we observe in the typical case that the median voter will either push  $t_L$  or  $t_P$  to its boundary  $\bar{t}$ . As a consequence, for any policy  $(\tau, L_B)$ , the level of redistribution that can be realized is constrained by the economy's upper bound on tax rates, which, as discussed in the introduction, may be constitutional in nature or reflect the state's capacity to collect taxes. Now any growth-oriented entrepreneurial economy involves a loss in gross income for the median voter that needs to be compensated for by transfers if it is to be politically viable. Whether the transfers are sufficiently large depends crucially on

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<sup>36</sup>Substituting the profits by their equilibrium values as provided in Proposition 1, we obtain for the net transfers to the median voter:

$$NT = \frac{w}{\bar{L}} \left[ t_P \left[ \left( \frac{\alpha}{1-\alpha} L_y - m \right) (1-s) + \chi(L_B)L_E \right] - t_L L_E - L_B \right]. \quad (19)$$

the upper bounds of taxation. As stated in the following proposition, any growth-oriented entrepreneurial policy can be supported by sufficient redistribution when  $\bar{t}$  is close enough to one:

**Proposition 4**

*If there exists an entrepreneurial economy  $(\hat{\tau}, \hat{L}_B)$  with higher aggregate output than a stagnant economy, then there also exists a constitutional upper limit of tax rates  $\bar{t}$  such that  $\hat{\tau} \in [\underline{\tau}, \bar{\tau}]$  and the median voter will prefer the entrepreneurial economy over a stagnant economy.*

The proof is given in appendix C.4. The intuition is straightforward: with  $\bar{t}$  sufficiently close to 1, it is feasible to implement any  $\tau$  with  $t_P$  close to 1. Hence, all profits can effectively be redistributed in the entrepreneurial economy via the lump-sum transfer, allowing all workers to benefit from the increase in aggregate output.

The main insight of Proposition 4 is that incentives for entrepreneurship by a high value of  $\tau$  as well as redistribution of profits by a sufficiently high value of  $t_P$  can be reconciled if the upper boundary on tax rates is very close to 1. However, if the upper and lower bounds on taxation are too low, it will not be possible to provide both incentives for economic feasibility and redistribution for the political viability of an entrepreneurial economy.

**Proposition 5**

*Let  $\underline{t} = 0$ . If  $\bar{t}$  is sufficiently low, the median voter will support a stagnant economy.*

The proof of Proposition 5 is given in appendix C.5. Intuitively, for sufficiently restrictive tax bounds, redistribution of profits via the lump-sum taxes can no longer compensate for the decrease in labor income associated with the entrepreneurial economy, so the median voter will prefer the stagnant economy.

Using the results in Propositions 4 and 5, we argue in the next proposition that for every growth-oriented entrepreneurial policy there exists a unique level of  $\bar{t}_c$  making the policy politically viable in an economy with  $\bar{t} \geq \bar{t}_c$  but not if  $\bar{t} < \bar{t}_c$ .<sup>37</sup>

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<sup>37</sup>More formally, let  $\underline{t} = 0$  and fix any entrepreneurial policy  $(\hat{\tau}, \hat{L}_B)$  with  $\hat{L}_y \geq L_y^S$ . Proposition 4 implies that this entrepreneurial economy will be preferred to the stagnant economy by the median voter if  $\bar{t}$  is sufficiently high. Proposition 5 implies that this is no longer the case if  $\bar{t}$  is sufficiently low. In principle, there are two possibilities why this might happen: first,  $\bar{t}$  might prevent sufficiently large transfers to the median voter; second, for  $\bar{t}$  too low,  $\hat{\tau}$  might no longer be available, i.e. we might have  $\hat{\tau} \notin [\underline{\tau}, \bar{\tau}]$ . Let us say that the entrepreneurial economy  $(\hat{\tau}, \hat{L}_B)$  is *feasible* in the median voter framework if  $\hat{\tau} \in [\underline{\tau}, \bar{\tau}]$  and if it is preferred to the stagnant economy by the median voter. Then, for

### Proposition 6

Let  $\underline{t} = 0$ . For any growth-oriented entrepreneurial policy  $(\hat{\tau}, \hat{L}_B)$ , there exists a critical value  $0 < \bar{t}_c < 1$  such that  $\hat{\tau} \in [\underline{\tau}, \bar{\tau}]$ , and the median voter will prefer the entrepreneurial policy over the stagnant economy if and only if  $\bar{t} \geq \bar{t}_c$ .

The proof of Proposition 6 is given in appendix C.6. The key observation is now that each growth-oriented entrepreneurial policy is associated with a unique  $\bar{t}_c$ . Hence, considering the entire set of growth-oriented entrepreneurial policies, we can determine the infimum  $\bar{t}_{inf} = \inf \{\bar{t}_c\}$ . This infimum of critical upper tax bounds is particularly interesting as it tells us that an economy will only be able to escape a stagnant policy regime if its constitutional upper bound on taxes or its fiscal capacity is sufficiently large to satisfy  $\bar{t} \geq \bar{t}_{inf}$ . We summarize this insight in the next corollary, which follows immediately from Proposition 6:<sup>38</sup>

### Corollary 2

*The median voter will opt for a growth-oriented entrepreneurial policy if and only if  $\bar{t} \geq \bar{t}_{inf}$ . Otherwise, the median voter will support the stagnant economy.*

Note that  $\bar{t}_{inf} > 0$  follows directly from Proposition 5. Corollary 2 implies that entrepreneurial policies are precluded if upper tax bounds are too low and the society is ‘trapped’ in a stagnant economy. Upper bounds on taxation specified in the constitution are frequently intended to protect against expropriation, in particular to protect the wealthy members of society. Our analysis suggests that such policy instruments need not always be efficient. While for a given policy  $\tau, L_B$ , workers with large shareholdings (i.e.  $\tilde{s} > 1 + \frac{L_E[\chi(L_B) - \frac{1}{\tau}]}{\frac{\alpha}{1-\alpha}L_y - m}$ ) will prefer to have a low upper tax bound,<sup>39</sup> this is not necessarily the case if the policy  $\tau, L_B$  is determined in the political process. In such cases, wealthy households with at least as many shares as the median voter may prefer to have a higher  $\bar{t}$ . The following corollary is a manifestation of this logic:

### Corollary 3

*Consider two upper tax bounds  $\bar{t}_h$  and  $\bar{t}_l$  satisfying  $\bar{t}_h > \bar{t}_{inf} > \bar{t}_l$ . Then we can always*

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every such entrepreneurial economy there must exist a threshold value  $\bar{t}_c^l$  such that the entrepreneurial economy is no longer feasible if  $\bar{t} < \bar{t}_c^l$  and a threshold value  $\bar{t}_c^u$  such that the entrepreneurial economy is feasible if  $\bar{t} \geq \bar{t}_c^u$ . We summarize these insights in Proposition 6 and show in appendix C.6 that these two threshold values coincide.

<sup>38</sup>Recall that we are disregarding policies with output-decreasing entrepreneurship and/or basic research.

<sup>39</sup>The result follows from the fact that for  $\tau$  and  $L_B$  given, their net transfers decrease in  $t_P$  by equation (B.2).

find parameter values such that the wealthy households with shareholdings  $\tilde{s} > s$  will prefer living in an economy with  $\bar{t}_h$  to living in an economy with  $\bar{t}_l$ .

Corollary 3 follows immediately from consideration of the limiting case of  $\bar{L} = \frac{m}{\alpha}$ . Here the final-good producer has zero profits in the stagnant economy and shareholdings are worthless, irrespective of tax policies. Corollary 2 implies that the median voter with  $s$  shares will prefer any  $\bar{t} \geq \bar{t}_{inf}$  to any alternative  $\bar{t} < \bar{t}_{inf}$ . As all individuals with shareholdings larger than  $s$  will benefit even more from the profits accruing in a growth-oriented entrepreneurial economy, they will also prefer  $\bar{t}_h > \bar{t}_{inf}$  to  $\bar{t}_l < \bar{t}_{inf}$ .<sup>40</sup>

Such unintended harmful effects are not limited to constitutional tax bounds but may also apply to alternative means of protecting against excessive taxes. In particular, supermajority rules might have similar effects in our model.<sup>41</sup> Some entrepreneurial economies supported by the median voter may not be supported by voters with fewer shares and hence may not pass supermajority requirements.<sup>42</sup> It follows that for  $\bar{t}$  given, a society with supermajority requirements may be ‘trapped’ in a stagnant economy, whereas an entrepreneurial economy would be politically feasible in the median voter framework.

## 6.1 Numerical example

We now provide a numerical example to illustrate the arguments behind the political feasibility of entrepreneurial policies. We specify the parameters in the model such that an entrepreneurial economy matches OECD data on basic research expenditures and entrepreneurship and assume that output is 5.7% higher in the entrepreneurial than in a baseline stagnant economy. This corresponds to the average rate of total factor

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<sup>40</sup>A formal argument why all individuals with larger shareholdings than the median voter will prefer an entrepreneurial economy if the median voter does so is provided in appendix B.1.

<sup>41</sup>Several US states have supermajority rules for tax increases (cf. National Conference of State Legislatures (2010); Gradstein (1999) provides a historical overview). In the past, similar clauses have also been proposed at the federal level, but they have not been accepted (cf. Knight, 2000). These supermajority rules have also been addressed in the literature. Gradstein (1999) rationalizes them as a precommitment device for a benevolent government in a model with time-leading private productive investments. In his model, there is a time-inconsistency in the government’s preferences, as the government would like to levy high taxes once private investments have been made. Supermajority rules can help resolve this time-inconsistency. Knight (2000) presents US-based evidence suggesting that supermajority requirements do indeed have a dampening effect on taxes.

<sup>42</sup>Formally, in appendix B.1, we show that in our model the single-crossing condition holds for workers’ preferences over policies. In particular, in Lemma 3 we show that if a worker with shares  $\hat{s}$  prefers a growth-oriented entrepreneurial policy to the stagnant economy, then so do all workers with shares  $s \geq \hat{s}$ .

productivity growth in OECD countries between 1996 and 2006. The details of our parameter value choices are provided in appendix B.3.

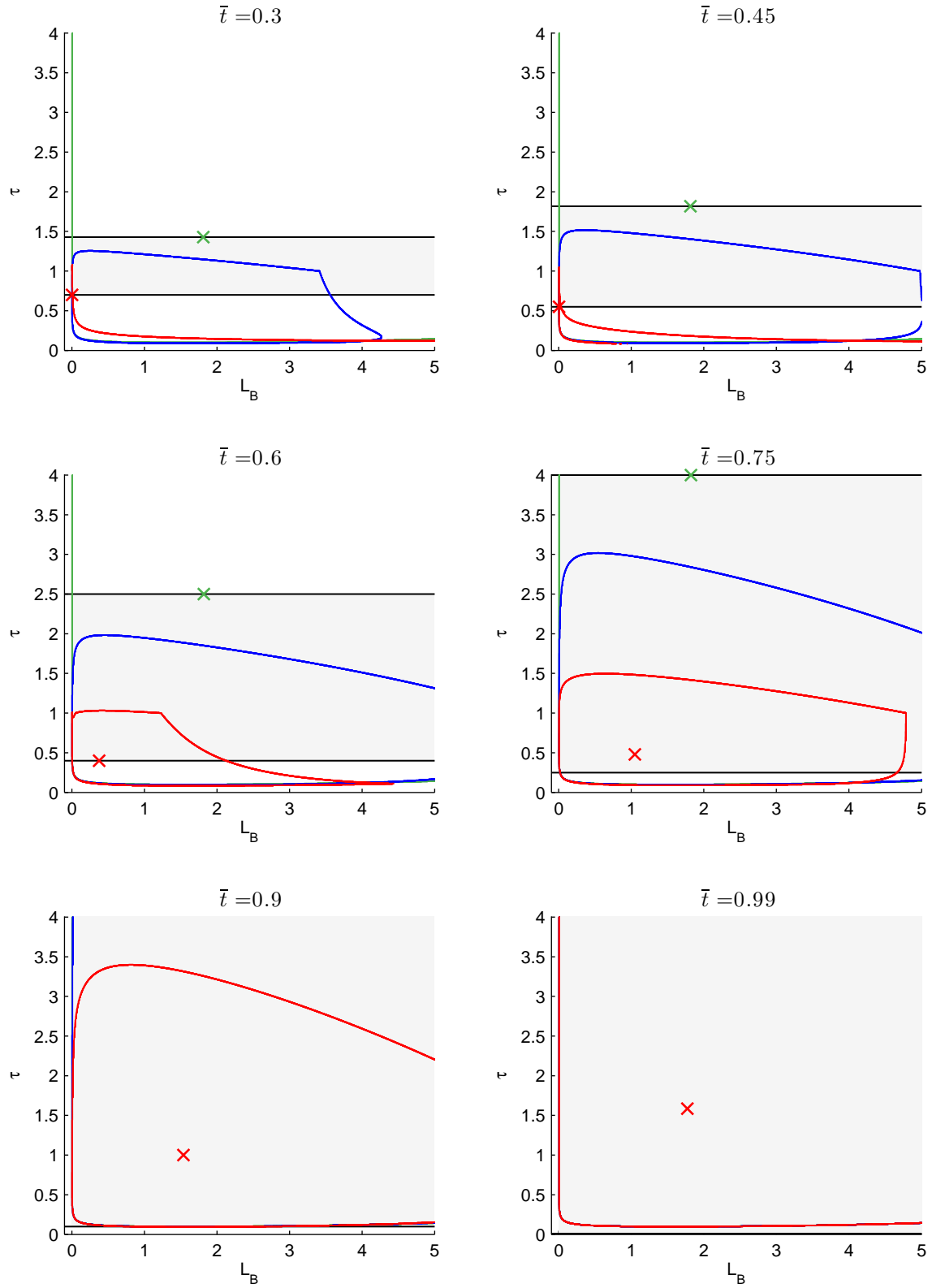
We use the calibration of our model to illustrate the effects of a change in the upper bound on taxation. For that purpose, we consider a median voter with  $s = 0.5$  shares.<sup>43</sup> Moving from the top-left panel to the bottom-right panel in Figure 2, the upper bound on tax rates,  $\bar{t}$ , increases from 0.3 to 0.99. In each of the panels in Figure 2, the black lines represent the smallest and largest level of  $\tau$  that is feasible with the respective upper tax bound. Only policies inside the area enclosed by these two lines – shaded in gray in Figure 2 – are feasible in the sense that  $\tau \in [\underline{\tau}, \bar{\tau}]$ . The green line in the policy space  $(\tau, L_B)$  indicates policy choices for which the condition (PLS) is equal to zero, thereby separating the growth-oriented entrepreneurial policies to the upper right of the line from the output-decreasing entrepreneurial policies on the lower left. A growth-oriented entrepreneurial policy in our context means that output is higher and the wage rates lower than in a stagnant economy. Accordingly, the median voter with a sufficiently small amount of shares in final-good production will not support a growth-oriented entrepreneurial policy without compensation from net transfers.

For each policy  $(\tau, L_B)$ , we can derive the median voter's optimal amount of net transfers given the upper bounds on tax rates,  $\bar{t}$ . We can then compare these net transfers to the net transfers in the stagnant economy. The blue lines in Figure 2 indicate entrepreneurial policies for which the net transfers are just as large as in the stagnant economy. Only in the area enclosed by these blue lines is the net transfer higher in the entrepreneurial economy, and we can thus hope for political support for a growth-oriented entrepreneurial policy. Adding up the differences in gross income and in net transfers between the entrepreneurial economy and the stagnant economy yields the difference in net income. All entrepreneurial policies for which this difference is positive are preferred by the median voter to the stagnant economy. In Figure 2, this is the case for all policies inside the areas enclosed by the red lines. All policies in the intersection of these areas with the areas shaded in gray are feasible in the sense that the median voter will prefer them to the stagnant economy and that  $\tau \in [\underline{\tau}, \bar{\tau}]$ . We note that the set of growth-oriented entrepreneurial policies supported by the median voter is a subset of the growth-oriented entrepreneurial policies where the net transfer difference is positive. This is because in the move from the stagnant policy to a growth-oriented entrepreneurial policy the median voter's gross income will decline.

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<sup>43</sup>In appendix B.4 we show results for  $s = 0$  and for  $s = 1$ , respectively.

Figure 2: Illustration of politically feasible entrepreneurial policies:  $s = 0.5$



Moving from the top-left panel to the bottom-right panel, the upper tax bound becomes larger, thereby increasing possibilities for redistribution. As our theory predicts, this increases the set of entrepreneurial policies with higher net transfers than in the stagnant economy, that is, it increases the area enclosed by the blue lines in the different panels. Of course, the higher redistributive possibilities imply that the balance between efficiency and redistribution can be achieved for a greater set of entrepreneurial policies. Consequently, the area enclosed by the red lines increases as well. In accordance with Proposition 4, we observe in the bottom-right panel that when  $\bar{t}$  approaches 1, the entire area comprising growth-oriented entrepreneurial policies will be politically viable. In the top-left panel we observe the opposite case, where the tax bound is too restrictive and the median voter will prefer the stagnant economy, as indicated by the red cross, which marks her most preferred policy. As  $\bar{t}$  increases, this most preferred policy becomes more growth-oriented, i.e. the median voter will prefer a higher  $\tau$  and a higher  $L_B$ . Yet this policy is clearly inefficient vis-à-vis the output-maximizing policy, as indicated by the green cross.

## 6.2 Discussion

The political process implies that tax policies can be inefficient – in the sense that aggregate output is not maximal – if the income distribution (in our case the distribution of shareholdings) is skewed to the right as in the classical findings by Romer (1975), Roberts (1977), and Meltzer and Richard (1981). We take the insights from this literature further as in our model such inefficiencies can arise both at the extensive and at the intensive margin. If bounds on taxation are too restrictive, then the median voter will prefer a stagnant economy to any growth-oriented entrepreneurial policy and her policy choice is inefficient at the extensive margin. If her preferred policy choice is an entrepreneurial policy, then inefficiency will arise vis-à-vis the optimal policies at the intensive margin. This inefficiency follows directly from the fact that  $t_P = 0$  maximizes aggregate consumption in an entrepreneurial economy and this can never be optimal from the point of view of the median voter. Both inefficiencies are the more severe, the fewer shares the median voter possesses, i.e. the more skewed the income distribution is. However, if  $\bar{t} = 1 - \varepsilon$  and  $\varepsilon \rightarrow 0$ , then the inefficiencies generally become arbitrarily small, irrespective of the median voter's shareholdings.<sup>44</sup>

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<sup>44</sup>This is not necessarily the case if the median voter can earn more than the per-capita income in the output-maximizing entrepreneurial economy. Cf. footnote 70.

The inefficiency also concerns basic research investments. Consider any choice of labor income and profit taxes,  $\hat{t}_L, \hat{t}_P$  with  $\hat{L}_B = \tilde{L}_B(\hat{\tau}) > 0$ , i.e. given this tax policy it is socially desirable to invest in basic research.<sup>45</sup> Then  $\frac{\partial L_y}{\partial L_B} \Big|_{\hat{t}_L, \hat{t}_P, \hat{L}_B} = 0$  but  $\frac{\partial L}{\partial L_B} \Big|_{\hat{t}_L, \hat{t}_P, \hat{L}_B} \neq 0$  in general. In fact, the median voter will typically invest too little in basic research vis-à-vis the social optimum. Intuitively, via a reduction in the lump-sum transfer, the median voter pays the per-capita share of any increase in basic research investments. However, she benefits less than average from the associated increase in aggregate output due to the decrease in gross income.<sup>46</sup> Interestingly, with the median voter investing less than the social optimum in basic research, the political equilibrium can help explain the surprisingly high rates of return to public (basic) research typically found in empirical studies.<sup>47</sup>

With bounds on taxation at center stage in our model, these results also have important implications for the design of tax rules in the constitution. Typically, decisions on tax bounds in the constitution are thought to be taken behind a veil of ignorance. We perform the simplest exercise in this framework. Suppose that the only uncertainty individuals face behind the veil of ignorance is the amount of shares they will possess. Knowing that after the resolution of the uncertainty the median voter will exhaust her possibilities for maximizing her income, a tax bound close to one will be implemented in the constitution. This will resolve the conflict between efficiency and equality that is present for lower constitutional tax bounds and will thus induce the median voter to opt for a more growth-oriented policy. In turn, this will increase the expected income of an individual before lifting the veil of ignorance.<sup>48</sup>

An alternative view on the upper bounds on taxation is to interpret them as a reduced form for fiscal capacity, as in Besley and Persson (2009) and Acemoglu (2005). Then our model provides a new and intuitive political economy rationale for why weak fiscal capacity may have a detrimental effect on economic growth. In the absence of strong fiscal capacities and with imperfect trickle-down effects of growth-oriented supply-side

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<sup>45</sup>Recall that we limit our attention to growth-oriented entrepreneurial economies. For  $\hat{t}_L, \hat{t}_P$  with  $\hat{L}_B = \tilde{L}_B(\hat{\tau}) = 0$  no such economy exists.

<sup>46</sup>For  $\hat{\tau} \geq 1$ , this can be shown analytically. In particular, suppose by contradiction that the median voter invests  $L'_B > \tilde{L}_B(\hat{\tau})$  in basic research. Note that for  $L_B = 0$  we have  $L_y(0, \hat{\tau}) \leq L_y^S$  and that by assumption we have  $L_y(L'_B, \hat{\tau}) \geq L_y^S$ . Then, by continuity of  $y$  in  $L_B$  and by the optimality of  $\tilde{L}_B(\hat{\tau})$ , there exists  $\tilde{L}_B < L'_B$  such that  $L_y(\tilde{L}_B, \hat{\tau}) = L_y(L'_B, \hat{\tau})$ . Now the median voter's gross income is the same for both choices of  $L_B$ . However,  $\chi(L'_B) > 1$  and  $\hat{\tau} \geq 1$  imply that net transfers are larger for  $\tilde{L}_B$  than for  $L'_B$ , a contradiction to  $L'_B$  being optimal for the median voter.

<sup>47</sup>Cf. Salter and Martin (2001) and Toole (2012), for example.

<sup>48</sup>The detailed argument can be found in appendix B.5.

policies, it may not be viable to sufficiently redistribute the gains from innovation for a majority of the population to support such policy changes.<sup>49</sup>

## 7 Conclusions

We have outlined a rationale for a taxation pecking order to finance basic research investments, thus presenting a new perspective on the theory of optimal income taxation. We have subsequently assumed a political economy perspective and characterized the conditions under which the optimal policy scheme is politically viable. In particular, our political economy analysis suggests that entrepreneurial policies may harm workers with little in the way of shareholdings. We have shown that upper bounds on taxation – explicitly specified in the constitution or implicitly arising from fiscal capacity – can undermine the political support for growth-stimulating policies. Hence our analysis provides a political economy rationale for why weak fiscal capacities are associated with low future income levels, the point being that the political process tends to result in inefficient policies vis-à-vis the social optimum. This inefficiency encompasses the amount of basic research investments, which tend to be too low. Our work may therefore also explain the surprisingly high rates of return to public investments in (basic) research frequently found in empirical studies.

The above findings have further implications for the design of tax constitutions. While upper bounds on taxation in constitutions are sometimes proposed as a means for protecting investors from excessive indirect expropriation, the mechanisms considered here suggest that such measures may only be efficient if growth policies are *given*. If, by contrast, growth policies are subject to the political process, they may actually harm the firm-owners they are meant to protect.

Future work may set out to integrate our analysis of the optimal financing of basic research investments into the theory on optimal taxation in the tradition of Mirrlees (1971). With concave utilities and the traditional supply-side effects of labor income

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<sup>49</sup>Within our model, if distributional reasons prevent the existence of an entrepreneurial economy, it may be optimal to tax profits in the final-good sector differently from those in the innovative intermediate-good sector. This would allow redistribution of profits from final-good firms without affecting occupational choices. Typically, such tax discrimination is either not possible or is limited in its scope. For instance, intermediate-good firms and final-good firms would find it profitable to integrate and to shift profits through transfer pricing to intermediate-good production. Moreover, asymmetric information regarding innovation capabilities makes it impossible for the government to distinguish between firms with promising innovation prospects and those with no such prospects.

taxation, optimal policies would account for losses in aggregate utility from income inequality and for potentially adverse effects on labor supply. These additional efficiency-equality trade-offs might push optimal tax policies towards a more egalitarian economy. Finally, in the presence of incomplete markets, concave utilities might also allow additional beneficial effects of basic research on entrepreneurship and thus innovation in the economy, as basic research can reduce idiosyncratic risks. While some of these extensions may mitigate the effects considered here, we believe that the underlying mechanisms are still at play and that they need to be taken into consideration when analyzing growth policies, both from a normative and from a positive perspective.

# Appendix

## A Robustness of taxation pecking order

### A.1 Optimal policy without lump-sum taxes and transfers

In section 5.2 separating the choice of  $L_B$  from  $\tau$  was feasible. We now ask whether this is always possible, even when lump-sum taxes or transfers are not available. It is possible when, for some given values of  $L_B$  and  $\tau$ , we can always find values of  $t_L$  and  $t_P$  resulting in the desired value of  $\tau$  and satisfying the budget constraint:

$$wL_B = wt_L [\bar{L} - L_E] + t_P [\pi_y + \eta(L_B)L_E\pi_{xm}]. \quad (\text{A.1})$$

Using the equilibrium values of  $\pi_y$ ,  $\pi_{xm}$ , and  $w$ , the budget constraint can be rewritten as:

$$L_B = t_L [\bar{L} - L_E] + t_P \left[ \frac{\alpha}{1-\alpha} L_y - m + L_E \chi(L_B) \right]. \quad (\text{A.2})$$

The right-hand side of equation (A.2) corresponds to the tax revenue in working-hour equivalents. It will subsequently be denoted by  $TR$ .

The definition of  $\tau$  yields  $t_L = 1 - \frac{1-t_P}{\tau}$ . Inserting this expression into equation (A.2) and solving for  $t_P$ , we find that the choice of  $L_B$  and  $\tau$  can be separated only if the resulting value of  $t_P$ , which we denote by  $\tilde{t}_P$ , is in the feasible range  $[\underline{t}_P, \bar{t}_P]$  and  $\tilde{t}_L = 1 - \frac{1-\tilde{t}_P}{\tau}$  is in  $[\underline{t}_L, \bar{t}_L]$ .<sup>50</sup> In the main text we saw that in the setting with lump-sum taxes either  $(\bar{\tau}, \tilde{L}_B(\bar{\tau}))$  or  $(\underline{\tau}, 0)$  is optimal. In this appendix we assume  $\underline{t}_L = \underline{t}_P = 0$ , as we want to allow the government not to provide basic research, if so desired. Then, by Assumption 1(ii), the policy choice  $t_L = t_P = L_B = 0$  also allows the realization of a stagnant economy without lump-sum taxes. By contrast,  $(\bar{\tau}, \tilde{L}_B(\bar{\tau}))$  is not feasible in general in the setting without lump-sum taxes, as it would require that  $(\tilde{t}_L, \underline{t}_P, \tilde{L}_B(\bar{\tau}))$  exactly satisfies equation (A.2).

To examine optimal policies in an economy without lump-sum taxes or transfers, we proceed as in section 5.2 and solve the government's maximization problem in two

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<sup>50</sup>The exact formula for  $\tilde{t}_P$  is:

$$\tilde{t}_P = \left( L_B + \frac{1-\tau}{\tau} (\bar{L} - L_E) \right) / \left( \frac{\alpha}{1-\alpha} L_y - m + L_E \chi(L_B) + \frac{\bar{L} - L_E}{\tau} \right).$$

steps. First, we consider the optimal tax policy given that a certain level of basic research needs to be financed. Consider the set of all tax policies  $\mathcal{T}(L_B)$  consisting of vectors  $(t_P, t_L)$ , with  $0 \leq t_P \leq \bar{t}_P$ ,  $0 \leq t_L \leq \bar{t}_L$ , that satisfy the budget constraint (A.2).<sup>51</sup> We focus on affordable basic research investments, i.e.  $\mathcal{T}(L_B) \neq \emptyset$ . For each such  $L_B$ , the policies in  $\mathcal{T}(L_B)$  define a feasible range of  $\tau$  whose upper and lower bounds are denoted by  $\bar{\tau}_O(L_B)$  and  $\underline{\tau}_O(L_B)$ , respectively. It transpires that the upper bound  $\bar{\tau}_O(L_B)$  will be reached by using the labor income tax to finance basic research and levying a positive profit tax only if a *ceteris paribus* increase in  $t_L$  cannot be used to finance additional basic research, i.e. with a pecking order in which labor income tax comes first. With a pecking order in which profit taxes come first, we will obtain the lower bound  $\underline{\tau}_O(L_B)$ . We note that it may not be possible to finance additional basic research by a unilateral increase of the preferential tax measure for two reasons: either because the preferential tax instrument has reached its upper constitutional bound or because it is located at the decreasing part of the Laffer curve for  $TR$ .

By definition, all policies in  $\mathcal{T}(L_B)$  satisfy the government's budget constraint. However, depending on the implied level of  $\tau$ , the tax policies entail different levels of entrepreneurship and consequently different output levels. Entrepreneurship increases aggregate consumption if  $\chi(L_B) \geq 1$ , i.e., if  $L_B \geq L_{B,min}$ . In this case, the government's tax policy will aim at maximizing entrepreneurship by maximizing  $\tau$  with the pecking order in which labor income tax comes first. By contrast, the opposite pecking order will be applied to minimize entrepreneurship if  $\chi(L_B) < 1$ .<sup>52</sup> We formalize these insights in Proposition 7.

**Proposition 7 (Taxation Pecking Order)**

Consider a government that maximizes aggregate consumption and finances an amount  $L_B$  of basic research using  $(t_L, t_P)$  as its tax scheme. Suppose  $\mathcal{T}(L_B) \neq \emptyset$ . Then:

- (i) If  $L_B \geq L_{B,min}$ , basic research should be financed using a pecking order with labor income tax coming first. In particular,  $t_P > 0$  only if  $TR$  cannot be increased further by a unilateral increase of  $t_L$ .
- (ii) If  $L_B < L_{B,min}$ , basic research should be financed using a pecking order with profit tax coming first. In particular,  $t_L > 0$  only if  $TR$  cannot be increased further by a unilateral increase of  $t_P$ .

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<sup>51</sup>Note that for  $L_B > 0$ , the Positive Profit Condition (PPC) is a necessary condition for the government budget constraint to be satisfied.

<sup>52</sup>In principle, there could exist several tax schemes that fully deter entrepreneurship. If the government is indifferent between such tax policies, we assume that it will choose  $\underline{\tau}_O(L_B)$ .

A proof of Proposition 7 can be found in appendix C.7.

Proposition 7 characterizes the optimal tax policies required to finance a given amount of basic research  $L_B$ . We will now use the optimal tax policies to determine the optimal provision of basic research. For this purpose, it is again convenient to consider first the constrained problem for  $L_B \geq L_{B,min}$ . In this case, the government's tax policy maximizes  $\tau$  for each given  $L_B$ . Inserting  $\bar{\tau}_O(L_B)$  into its objective function (see equation (13)), the government's problem boils down to:

$$\max_{\{L_B \geq L_{B,min}\}} L_y(L_B, \bar{\tau}_O(L_B)) .$$

We obtain as a necessary condition for a maximum:

$$\frac{\partial L_y(L_B, \bar{\tau}_O(L_B))}{\partial L_B} + \frac{\partial L_y}{\partial L_E} \frac{\partial L_E}{\partial \tau} \frac{\partial \bar{\tau}_O(L_B)}{\partial L_B} \leq 0 , \quad (\text{A.3a})$$

$$\left( \frac{\partial L_y(L_B, \bar{\tau}_O(L_B))}{\partial L_B} + \frac{\partial L_y}{\partial L_E} \frac{\partial L_E}{\partial \tau} \frac{\partial \bar{\tau}_O(L_B)}{\partial L_B} \right) (L_B - L_{B,min}) = 0. \quad (\text{A.3b})$$

The first partial derivative of the objective function  $L_y(\cdot, \cdot)$  with respect to  $L_B$  corresponds to the necessary condition for maximization of aggregate consumption when lump-sum taxes and transfers are feasible (16a). The second summand captures the effect of  $L_B$  on  $\tau$  implying that a marginal increase of basic research additionally influences the number of entrepreneurs making use of it via the tax scheme. The sign of  $\frac{\partial L_y}{\partial L_E}$  is positive for  $L_B > L_{B,min}$ . For  $L_E > 0$ , the term  $\frac{\partial L_E}{\partial \tau}$  is positive, which follows from the equilibrium value of  $L_E$  given in (6). Finally, the last expression represents the marginal effect of basic research on  $\bar{\tau}_O(L_B)$  as implied by the government budget constraint. The sign of this effect depends on two interdependent factors: first, it depends on whether or not an increase in  $L_B$  requires additional funding. An increase in  $L_B$  might in principle generate additional tax returns in working-hour equivalents exceeding the increase in  $L_B$ . Second, it depends on how precisely basic research is financed: via a change in labor income or via a change in profit taxes. Suppose, for example, that both tax measures are located at the increasing part of the Laffer curve and that an increase in basic research requires additional funding. Then, with the pecking order  $\bar{\tau}_O(L_B)$ , the government will use the labor tax to finance additional basic research, implying  $\frac{\partial \bar{\tau}_O(L_B)}{\partial L_B} = \frac{\partial \tau}{\partial t_L} \frac{\partial t_L}{\partial L_B} > 0$ . If, by contrast, an increase in  $L_B$  cannot be funded via an increase in the labor tax, either because it has reached its upper bound or because it is located at the decreasing part of the Laffer curve, then additional basic research will be financed by an increase in the profit taxes and/or a decrease in the labor tax, and the last expression becomes negative.

Let us use  $L_{B,\bar{\tau}_O}$  to denote the solution of the government's problem, constrained by  $L_B \geq L_{B,min}$ , which implies a pecking order with labor income taxes coming first. Again, note that  $L_{B,\bar{\tau}_O} > L_{B,min}$  implies that (A.3a) holds with equality.

Next, we consider the government's problem restricted to  $L_B < L_{B,min}$  implying a pecking order with profit taxes coming first,  $\underline{\tau}_O$ . Since, in this case, entrepreneurship affects consumption negatively, the government will prevent inefficient entrepreneurship by providing no basic research.<sup>53</sup> Hence the solution to this restricted optimization problem will be  $(L_{B,\underline{\tau}_O} = 0, \underline{\tau}_O(L_{B,\underline{\tau}_O}) = 1)$ .

Consequently, the government will implement  $L_{B,\bar{\tau}_O} > L_{B,min}$  if and only if basic research increases the entrepreneurs' innovation probability sufficiently to compensate for the investments in basic research and the labor diverted to entrepreneurship. That is, if and only if  $L_{B,\bar{\tau}_O}$  satisfies:

$$-L_{B,\bar{\tau}_O} + \left[ 1 - \frac{1}{\bar{\tau}_O(L_{B,\bar{\tau}_O})b \chi(L_{B,\bar{\tau}_O})} \right] [\chi(L_{B,\bar{\tau}_O}) - 1] \geq 0. \quad (\text{PLS2})$$

Otherwise, the government will implement policy  $L_B = t_P = t_L = 0$ . Proposition 8 summarizes our findings.

### Proposition 8

*Suppose the government maximizes aggregate consumption using  $(t_L, t_P, L_B)$  as policy instruments. Then:*

- (i) *If and only if condition (PLS2) is satisfied, there will be an entrepreneurial economy with  $L_B^* = L_{B,\bar{\tau}_O}$ ,  $\tau^* = \bar{\tau}_O(L_{B,\bar{\tau}_O})$ , and  $L_E = 1 - \frac{1}{\bar{\tau}_O(L_{B,\bar{\tau}_O})b\chi(L_{B,\bar{\tau}_O})}$ .*
- (ii) *Otherwise, there will be a stagnant economy with  $t_L^* = t_P^* = 0$ ,  $L_B^* = 0$  and  $L_E = 0$ .*

## A.2 Maximization of aggregate welfare

In this part of the appendix we analyze the case of a government aiming to maximize aggregate utility rather than aggregate consumption. We reintroduce lump-sum taxes, again allowing the government to separate the choice of the optimal amount of basic research from the optimal financing scheme. In our model aggregate utility,  $W$ , is given

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<sup>53</sup>Note that the government is able to deter inefficient entrepreneurship by forgoing any basic research investment according to Assumption 1. Via the budget constraint,  $L_B = 0$  implies  $t_P = t_L = 0$ .

by:

$$W = (1 - t_P)\pi_y + \int_0^{L_E} [(1 - t_P)\lambda_k\eta(L_B)\pi_{xm} - t_H] dk + \int_{L_E}^{\bar{L}} [(1 - t_L)w - t_H] dk . \quad (\text{A.4})$$

Combining (A.4) with the government budget constraint, (4), the labor market clearing condition, (9), and the aggregate income identity,  $y = \pi_y + \eta(L_B)L_E\pi_{xm} + (L_x + L_y)w$ , yields:

$$W = y + (1 - t_P)\eta(L_B)\pi_{xm} \int_0^{L_E} (\lambda_k - 1) dk .$$

Replacing  $y$  and  $\pi_{xm}$  by their respective equilibrium values given in part (i) of Proposition 1 and solving the integral using  $\lambda_k = (1 - k)b$  yields:

$$W = L_y^{1-\alpha} + (1 - t_P)\chi(L_B)(1 - \alpha)bL_y^{-\alpha}L_E \left[ 1 - \frac{1}{b} - \frac{L_E}{2} \right] . \quad (\text{A.5})$$

The government's problem is to maximize (A.5) subject to the non-negativity constraint of the final-good producer's profits and equilibrium conditions (1) and (3) given in Proposition 1.

Comparing the expression for aggregate welfare given in equation (A.5) with the expression for aggregate consumption given in equation (13), makes it apparent that aggregate welfare corresponds to aggregate consumption plus the immaterial benefits (cost) of entrepreneurs. This immaterial utility term is scaled by  $(1 - t_P)$ , i.e. profit taxes allow the government to directly affect this term. So when maximizing aggregate welfare, not only the relative size of  $(1 - t_P)$  compared to  $(1 - t_L)$  matters, but also its absolute size. The imposition of labor income taxes affects the occupational choice of potential entrepreneurs and hence the equilibrium number of entrepreneurs who use the basic research provided. The imposition of profit taxes also influences the occupational choice of potential entrepreneurs. In addition it affects the utility received by those who opt to become entrepreneurs. Proposition 9 shows that this implies that, in any welfare optimum with strictly positive entrepreneurship, at least one tax measure is located at the boundary of its feasible set. The intuition is that for any strictly interior combination of tax measures, there is a continuum of combinations of  $t_L$  and  $t_P$  yielding the same  $\tau$  and hence the same level of entrepreneurship in the economy. Now, if for a given  $\tau$  the immaterial utility term in the aggregate welfare is positive, then the welfare-maximizing combination of  $t_L$  and  $t_P$  yielding this  $\tau$  is the

$t_P$ -minimizing combination, which requires that either  $t_L = \underline{t}_L$  or  $t_P = \underline{t}_P$  or both. A similar argument reveals that either  $t_L = \bar{t}_L$  or  $t_P = \bar{t}_P$  or both if the immaterial utility term in the aggregate welfare is negative.<sup>54</sup>

**Proposition 9**

Let  $(t_L^*, t_P^*, t_H^*, L_B^*)$  be a welfare optimum with  $\tau^* := \frac{1-t_P^*}{1-t_L^*} > \frac{1}{\chi(L_B^*)b}$ . Then at least one tax rate is at the boundary of its feasible set, i.e.  $t_P^* = \underline{t}_P$ ,  $t_P^* = \bar{t}_P$ ,  $t_L^* = \underline{t}_L$  or  $t_L^* = \bar{t}_L$ .

Proposition 9 follows directly from Proposition 12 in appendix C.8. It implies that no interior optimum exists for tax policies. We next characterize the optimal tax policy for a given  $L_B$  in more detail. As we have argued previously, depending on whether or not the immaterial utility term in the aggregate welfare is positive, it is optimal to either implement the desired  $\tau$  in the  $t_P$ -minimizing or the  $t_P$ -maximizing way. We now assume the opposite perspective and consider the optimal level of  $\tau$  given  $t_P$ . We show that tax neutrality, i.e. a tax policy satisfying  $t_L = t_P$ , is not welfare-maximizing in general.

For  $t_P$  given,  $\tau$  is determined by  $t_L$ , which only affects entrepreneurship in the economy. In particular, the following relationship between the marginal effect of labor income taxes and entrepreneurship on aggregate welfare holds:

$$\frac{\partial W}{\partial t_L} = \begin{cases} \frac{\partial W}{\partial L_E} \frac{1}{(1-t_P)\chi(L_B)b} & , \quad \text{if } \frac{1-t_L}{(1-t_P)\chi(L_B)b} \leq 1 \\ 0 & , \quad \text{if } \frac{1-t_L}{(1-t_P)\chi(L_B)b} > 1 \end{cases} .$$

We will make use of this relationship between  $\tau$ ,  $t_L$ , and  $L_E$  for given  $t_P$  and  $L_B$  and analyze welfare effects of entrepreneurship directly, which yields the most insights. The partial derivative of  $W$  with respect to  $L_E$  is given by:

$$\frac{\partial W}{\partial L_E} = (1-\alpha)L_y^{-\alpha} \left\{ (\chi(L_B) - 1) + (1-t_P)\chi(L_B)b \left[ \left(1 - \frac{1}{b} - L_E\right) - \alpha(\chi(L_B) - 1)L_y^{-1} \left(1 - \frac{1}{b} - \frac{L_E}{2}\right) L_E \right] \right\} .$$

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<sup>54</sup>The case where the aggregate immaterial utility term is exactly equal to zero is somewhat more involved. The intuition here is that in this case aggregate welfare will reduce to aggregate consumption, which we have shown previously to be maximized at either  $\bar{\tau}$  or  $\underline{\tau}$ .

Rearranging terms yields:

$$\begin{aligned}
\frac{\partial W}{\partial L_E} = & - (1 - \alpha)L_y^{-\alpha} + (1 - \alpha)L_y^{-\alpha}\chi(L_B)b(1 - L_E) \\
& - t_P(1 - \alpha)L_y^{-\alpha}\chi(L_B)b\left(1 - \frac{1}{b} - L_E\right) \\
& - (1 - t_P)\alpha(1 - \alpha)L_y^{-1-\alpha}\chi(L_B)b(\chi(L_B) - 1)\left(1 - \frac{1}{b} - \frac{L_E}{2}\right)L_E.
\end{aligned} \tag{A.6}$$

Equation (A.6) characterizes the trade-offs faced by the social planner when considering a marginal increase of entrepreneurship in the economy. It reveals why tax neutrality, i.e.  $t_L = t_P$ , is not welfare-maximizing in our economy in general.

The first summand represents the marginal product of labor used in final-good production – which corresponds to the pre-tax wage in equilibrium,  $(1 - \alpha)L_y^{-\alpha}$ . This is lost as the marginal entrepreneur is not available for production anymore.  $(1 - \alpha)L_y^{-\alpha}\chi(L_B)b(1 - L_E)$  is the pre-tax expected utility for this marginal entrepreneur. Assume tax neutrality, i.e.  $t_P = t_L$ , then the first two summands exactly reflect the trade-off faced by the marginal entrepreneur, so they cancel. To see this, note that under tax neutrality each potential entrepreneur  $k$  compares his pre-tax wage earned in the labor market,  $(1 - \alpha)L_y^{-\alpha}$ , with the pre-tax expected utility from being an entrepreneur,  $(1 - \alpha)L_y^{-\alpha}\chi(L_B)b(1 - k)$ . The result then follows from  $k = L_E$  for the marginal entrepreneur.

By contrast, the remaining two summands in equation (A.6) do not necessarily vanish under tax neutrality.  $-t_P(1 - \alpha)L_y^{-\alpha}\chi(L_B)b\left(1 - \frac{1}{b} - L_E\right)$  captures the immaterial utility of the marginal entrepreneur that is lost due to profit taxes. For the occupational choice of the marginal entrepreneur, only the relation of profit to labor income taxes matters, so it is not affected by tax-neutral policies. Furthermore, with regard to consumption, for a constant  $\tau$ ,  $t_L$  and  $t_P$  have purely distributional effects that do not matter for aggregate welfare in our economy. However,  $t_P$  does not only decrease the expected after-tax profits of the marginal entrepreneur but also his immaterial utility. This reduction in immaterial utility for the marginal entrepreneur lowers aggregate welfare. It could be eliminated by having  $t_L = t_P = 0$ .

The last summand captures the effect of the marginal entrepreneur on equilibrium wages, which affects the immaterial utility of all other entrepreneurs. The sign of this effect depends on two factors. First, it depends on  $1 - \frac{1}{b} - \frac{L_E}{2} \geq 0$ , which determines whether the total sum of these immaterial utilities is positive or negative. Second, it depends on whether  $\chi(L_B)$  is greater or smaller than one, which determines whether

the marginal entrepreneur has a positive or a negative effect on equilibrium wages. This term does not vanish in general for  $t_L = t_P = 0$ .

In summary, we have argued that any given level  $\tau$  should be implemented either in a  $t_P$ -minimizing or in a  $t_P$ -maximizing way and that tax neutrality is not optimal in general. Taken together, these two observations give rise to *taxation pecking orders* and hence reinforce our main insights from the analysis of aggregate consumption-maximizing policies. Proposition 10 establishes the welfare-maximizing pecking orders formally, where  $(t_L^*, t_P^*, L_E^*)$  again denote optimal policy choices and  $L_E^*$  denotes the resulting equilibrium level of entrepreneurship in the economy.

**Proposition 10 (Welfare-Optimal Taxation Pecking Order)**

*The welfare optimal tax policy for economies with positive entrepreneurship,  $L_E^* > 0$ , can be characterized as follows:*

- (i) if  $L_E^* < \min \left\{ 1 - \frac{1-\underline{t}_L}{(1-\underline{t}_P)\chi(L_B^*)b}, 2 \left( 1 - \frac{1}{b} \right) \right\}$ , then  $t_P^* > \underline{t}_P$  and  $t_L^* = \underline{t}_L$ ;
- (ii) if  $1 - \frac{1-\underline{t}_L}{(1-\underline{t}_P)\chi(L_B^*)b} < L_E^* < 2 \left( 1 - \frac{1}{b} \right)$ , then  $t_P^* = \underline{t}_P$  and  $t_L^* > \underline{t}_L$ ;
- (iii) if  $2 \left( 1 - \frac{1}{b} \right) < L_E^* < 1 - \frac{1-\bar{t}_L}{(1-\bar{t}_P)\chi(L_B^*)b}$ , then  $t_P^* = \bar{t}_P$  and  $t_L^* < \bar{t}_L$ ;
- (iv) if  $L_E^* > \max \left\{ 1 - \frac{1-\bar{t}_L}{(1-\bar{t}_P)\chi(L_B^*)b}, 2 \left( 1 - \frac{1}{b} \right) \right\}$ , then  $t_P^* < \bar{t}_P$  and  $t_L^* = \bar{t}_L$ .

A proof including all cases of Proposition 10 and knife-edge cases is given in appendix C.8.

Cases (i) and (iii) of Proposition 10 give rise to a pecking order with profit taxes coming first in the sense that either  $t_L$  is at its lower bound and  $t_P$  is not, or  $t_P$  is at its upper bound and  $t_L$  is not. Conversely, cases (ii) and (iv) give rise to a pecking order with labor income tax coming first.

Note, however, that as opposed to the setting without lump-sum taxes considered in appendix A.1, the pecking order in this part of the appendix is not a result of the government seeking to raise additional funds in order to finance basic research once the preferred tax measure cannot be used any further. Optimal tax policies are rather driven by the endeavor to implement a preferred  $\tau$  either in a  $t_P$ -maximizing or in a  $t_P$ -minimizing way, as discussed above. In cases (i) and (ii) of Proposition 10, for example, the aggregate extra (dis)-utility of entrepreneurs is positive ( $L_E^* < 2 \left( 1 - \frac{1}{b} \right)$ ), and hence the government seeks to have a minimal  $t_P$  in order not to lose this extra utility, primarily using  $t_L$  to induce the desired level of entrepreneurship.

If entrepreneurship is desirable from a social-welfare perspective, the government will opt for  $t_L^* > \underline{t}_L$  to incentivize entrepreneurship (case (ii)). If entrepreneurial activity becomes less attractive, the government first responds by decreasing  $t_L$  to discourage entrepreneurship and once  $t_L$  cannot be relied upon any further because it has reached its lower bound, it will increase  $t_P$ , thereby trading-off the social-welfare gain from continuing to discourage entrepreneurship against the cost of losing some of the extra utility earned by entrepreneurs (case (i)). As a side-effect, the pecking orders derived here are solely characterized by bounds of taxation. In particular, peaks of the Laffer Curves, which played a central role in the pecking orders derived in appendix A.1, do not matter in this part of the appendix.

Note further that the underlying motives for the two cases yielding the same pecking order according to Proposition 10 are different. Consider for example case (iii) of Proposition 10 as opposed to case (i), both of which motivate a pecking order with profit taxes coming first. In case (iii), the aggregate extra (dis)-utility term of entrepreneurs is negative ( $L_E^* > 2(1 - \frac{1}{b})$ ), so the government will choose  $t_P^* = \bar{t}_P$  to minimize these welfare losses for any given level  $L_E$ . In addition, it will use  $t_L$  to further discourage entrepreneurship and hence choose  $t_L < \bar{t}_L$ .

Finally, although we have just identified differences between the pecking orders, it is important to note that from a more fundamental perspective they share the same motive: the pecking order with profit taxes coming first is preferable whenever the desired level of entrepreneurship is relatively low. By contrast, the pecking order with labor income tax coming first is preferable whenever the desired level of entrepreneurship is relatively high. In the setting considered here, a relatively high level of entrepreneurial activity means:

- a level larger than the one implied by  $t_L = \underline{t}_L$  and  $t_P = \underline{t}_P$  if aggregate immaterial utility from entrepreneurship is positive (case (ii));
- a level larger than the one implied by  $t_L = \bar{t}_L$  and  $t_P = \bar{t}_P$  if aggregate immaterial utility from entrepreneurship is negative (case (iv)).

We summarize these qualitative results in the following Corollary:

**Corollary 4**

*Suppose the government maximizes aggregate welfare, given by (A.5), using  $(t_L, t_P, t_H, L_B)$  as policy instruments. Then:*

- (i) *If the welfare-optimal level of entrepreneurial activity is relatively high, then the*

government will opt for the pecking order with labor income tax coming first.

- (ii) If the welfare-optimal level of entrepreneurial activity is relatively low, then the government will opt for the pecking order with profit tax coming first.

The welfare-optimal level of entrepreneurial activity depends on a variety of different factors. In particular, it depends on the effectiveness of entrepreneurship in terms of labor saved in intermediate-good production,  $\chi(L_B^*)$ , and on the immaterial benefits from entrepreneurship as determined by  $b$ .

Proposition 10 limits its attention to economies in which entrepreneurs are active, i.e.  $L_E > 0$ . Economically, this is not very restrictive for the purpose of our analysis, as in an economy where  $L_E^* = 0$ , trivially  $L_B^* = 0$  combined with any tax policy ensuring that  $L_E^* = 0$  would be welfare-maximizing. Proposition 11 analyzes the circumstances when  $L_E^* > 0$  is welfare-optimal for given  $L_B$ . Whether or not  $L_E^* > 0$  is only interesting for cases where  $L_E = 0$  and  $L_E > 0$  are both feasible, which is why we limit our attention to these cases.<sup>55</sup>

**Proposition 11**

Suppose that  $L_B = L_B^*$  and let  $L_E = 0$  and  $L_E > 0$  both be feasible. Then  $L_E^* > 0$ , i.e. positive entrepreneurship is welfare-maximizing, if:

$$\chi(L_B^*) > \frac{1}{1 + (1 - \tilde{t}_P)(b - 1)} , \quad (\text{A.7})$$

where

$$\tilde{t}_P = \begin{cases} \min \left( \bar{t}_P, 1 - \frac{1 - \bar{t}_L}{\chi(L_B^*)b} \right) & \text{if } b \leq 1 \\ \max \left( \underline{t}_P, 1 - \frac{1 - \underline{t}_L}{\chi(L_B^*)b} \right) & \text{if } b > 1 \end{cases} . \quad (\text{A.8})$$

A proof of Proposition 11 is given in appendix C.9. Proposition 11 implies quite intuitively that  $L_E^* > 0$  is welfare-optimal whenever  $\chi(L_B^*)$  is large, i.e. whenever the expected labor saved for final-good production from increasing the number of entrepreneurs is large.

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<sup>55</sup>Note that in our model feasibility of a given level  $L_E$  does not only require the existence of a combination of tax measures  $t_L$  and  $t_P$  that yield the desired level of entrepreneurial activity given  $L_B$ , but also that this results in non-negative profits for the final-good producer.

## B Details on political economy analysis

### B.1 Applicability of median voter theorem

In this part of the appendix, we give sufficient conditions under which the median voter theorem holds in our model. We start by elaborating on whether the preferences of the individuals satisfy the single-crossing condition over the policy space.

Consider policy space  $\mathcal{P}$  with policies  $p = (t_L, t_P, t_H, L_B)$  that either reflect a stagnant economy with  $L_B = 0$  or growth-oriented entrepreneurial policies with  $L_B > 0$ . We order the policies according to their implied net final-good profit,  $(1 - t_P)\pi_y$ , such that if  $p_2 > p_1$  then  $(1 - t_P^2)\pi_y^2 > (1 - t_P^1)\pi_y^1$ . We further order the voters according to their shareholdings. The single-crossing condition requires that if  $p > p'$  and  $s < s'$ , or if  $p < p'$  and  $s > s'$ , then from  $EU_s(p) > EU_s(p')$  it follows that  $EU_{s'}(p) > EU_{s'}(p')$ . In this condition,  $EU_s(p)$  refers to the expected utility of an individual with shareholdings  $s$  under policy  $p \in \mathcal{P}$ , which can be written as:

$$EU_s(p) = (1 - t_L)w - t_H + s(1 - t_P)\frac{\pi_y}{\bar{L}} + \mathbb{1}_{k \in [0,1]} \max \{ (1 - t_P)\pi_{xm}\eta(L_B)(1 - k)b - (1 - t_L)w, 0 \} . \quad (\text{B.1})$$

We immediately observe that the single-crossing condition holds for the preferences of all individuals with  $k \geq 1$ , i.e. when we exclude all potential entrepreneurs. Consider two policies  $p_1$  and  $p_2$  with  $p_2 > p_1$ . If a worker with shareholdings  $s_1$  prefers policy  $p_2$ , so will a worker with shareholdings  $s_2 > s_1$ . Further, if the person with shares  $s_2$  prefers  $p_1$  to  $p_2$ , so will the individual with shares  $s_1$ . Intuitively, the labor income and the lump-sum transfers are always the same for both workers, but the worker with the higher amount of shares benefits more from a policy involving higher net profits in final-good production. We summarize this finding in the following lemma:

**Lemma 2**

*The preferences of the individuals with  $k \notin [0, 1)$  satisfy the single-crossing condition over the policy space  $\mathcal{P}$ .*

When we consider the entire set of agents (i.e. including the set of potential entrepreneurs), the single-crossing condition does not hold. This can be illustrated by restricting the vote to one between a stagnant and an entrepreneurial policy, for instance by assuming that the stagnant economy is the status quo challenged by an

entrepreneurial policy proposal. Recall that for the single crossing condition to hold in this case, the following must be true: If the individual with the median amount of share prefers (disfavors) the entrepreneurial policy, so will all individuals with weakly higher (lower) shareholdings. It follows directly from equation (B.1) and Lemma 2 that the first statement, which we recall in the next lemma, is satisfied but the statement in parentheses is not.

**Lemma 3**

*Suppose a worker with shareholdings  $\hat{s}$  prefers a growth-oriented entrepreneurial economy to the stagnant economy. Then so will all voters with shareholdings  $s \geq \hat{s}$ .*

Intuitively, the higher a worker's shareholdings, the more he can benefit from the increase in final-good producers' profits associated with a growth-oriented entrepreneurial economy. (This is implied by Lemma 2.) The result extends to potential entrepreneurs with shareholdings  $s \geq \hat{s}$ , as they will all be workers in the stagnant economy. Then if they remain workers in the entrepreneurial economy, their trade-off is just the same as the one faced by a worker with the same shareholdings. If, by contrast, they opt to become entrepreneurs, they must prefer this option to being workers and the result follows accordingly. Note that for agents with  $0 \leq k \leq 1$  the decision whether to become an entrepreneur is captured by the maximum term in equation (B.1).

The reverse of Lemma 3 is not true. In particular, if a worker with shareholdings  $s$  prefers the stagnant economy, a potential entrepreneur with shareholdings equal to or less than  $s$  will not necessarily support a stagnant economy. This follows immediately from the fact, incorporated in equation (B.1), that the utility gain from being an entrepreneur must be weakly positive.

Hence, the single-crossing condition regarding a stagnant policy and an entrepreneurial policy does not hold for the entire set of individuals. Moreover, note that the single-crossing condition does not necessarily hold when we consider the voting on two different entrepreneurial policies. The reason is the expected gain from being an entrepreneur, as described in (B.1). To illustrate the argument, consider two policies  $p_1 > p_2$ . Suppose that a worker with  $\hat{s}$  shares prefers policy  $p_2$  to policy  $p_1$ . Now consider an entrepreneur with  $\hat{s}$  shares as well. Note that her absolute expected gain from being an entrepreneur as described in (B.1) may be larger for policy  $p_1$  than for policy  $p_2$ . So, she may prefer policy  $p_1$ .

The type of preferences of potential entrepreneurs can imply that the amount of shares

of the median voter may be different across different binary collective decisions. This inhibits the direct application of the median voter theorem. However, when we order individuals from 1 to  $\bar{L}$  according to the amount of shares they own, starting with the lowest amount at  $k = 1$ , and if  $\bar{L} > 2$ , we will observe that the median voter on any collective decision between  $p_1$  and  $p_2$  is in  $\left[\frac{\bar{L}}{2}, \frac{\bar{L}}{2} + 1\right]$ . The preferences of potential entrepreneurs can affect the location of the median voter on some binary decisions in the interval  $\left[\frac{\bar{L}}{2}, \frac{\bar{L}}{2} + 1\right]$ .<sup>56</sup> All our results apply, as long as the shareholdings  $s$  of workers  $\left[\frac{\bar{L}}{2}, \frac{\bar{L}}{2} + 1\right]$  fulfill the conditions required in section 6.<sup>57</sup>

To simplify the presentation, we assume that all workers in  $\left[\frac{\bar{L}}{2}, \frac{\bar{L}}{2} + 1\right]$  have the same amount of shares  $s$ . Accordingly, if these workers prefer policy  $p_1$  to  $p_2$ , at least half of the electorate will have the same preference ordering. The single-crossing property of the preferences of individuals  $[1, \bar{L}]$  then implies the median voter theorem. The votes of potential entrepreneurs in  $[0, 1]$  will not affect the outcome of any binary collective decision  $p_1$  against  $p_2$ .

## B.2 Most-preferred policy of the median voter

In this section we consider the median voter's problem and derive her most-preferred policy. As described in the main text, we start with a given  $(\tau, L_B)$  and derive the optimal choice of  $t_P$  and  $t_L$ . Then we elaborate on the desired levels of  $(\tau, L_B)$ .

With  $\tau$  given, we can replace  $t_L$  by  $1 - (1 - t_P)/\tau$  in expression (19) for the net transfers. Then taking the derivative of the net transfers with respect to  $t_P$  yields:

$$DNT := \frac{\partial NT}{\partial t_P} \Big|_{\tau} = w \left[ \left( \frac{\alpha}{1 - \alpha} l_y - m_l \right) (1 - s) + \chi(L_B) l_E - \frac{l_E}{\tau} \right], \quad (\text{B.2})$$

where we use  $l_y := \frac{L_y}{\bar{L}}$ ,  $m_l := \frac{m}{\bar{L}}$ , and  $l_E := \frac{L_E}{\bar{L}}$  to denote per-capita variables. Note that with lump-sum transfers, a marginal increase in profit tax constitutes a redistribution of profits (from entrepreneurs and the final-good firm) to workers, while an increase in the labor tax redistributes from workers to entrepreneurs.<sup>58</sup> The redistribution of

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<sup>56</sup>Note that if the worker with  $k = \frac{\bar{L}}{2}$  prefers an entrepreneurial to a stagnant policy, all individuals in  $\left[\frac{\bar{L}}{2}, \bar{L}\right]$  will support the former.

<sup>57</sup>Even if collective decisions displayed cycles, these would remain in the set of most-preferred policies for workers in  $\left[\frac{\bar{L}}{2}, \frac{\bar{L}}{2} + 1\right]$ .

<sup>58</sup>The increase in labor tax does not per se constitute a redistribution towards the owners of the shares of the final-good firm, as these are also either workers or entrepreneurs.

profits is captured by the first two summands in (B.2). The first summand reflects the additional redistribution of the final-good firm's profits, the second represents the additional redistribution of entrepreneurial profits. As the median voter is a worker, she will prefer redistribution of entrepreneurial profits. Factor  $1 - s$  indicates that the redistribution of the final-good firm's profits is only favorable if she owns less than the per-capita shares in the final-good firm. Finally, keeping  $\tau$  constant, an increase in the profit tax  $t_P$  by a marginal unit must be matched by an increase in the labor tax  $t_L$  of  $1/\tau$ . The resulting amount of redistribution of labor income to entrepreneurs is captured by the last summand in  $DNT$ .

If  $DNT$  is positive, net transfers for the median voter are maximized by the highest possible profit tax rate, while the opposite is true if  $DNT$  is negative. However, the optimal choice of  $t_P$  (and  $t_L$ ) will depend on the particular value of  $\tau$ . Table 1 shows the optimal levels of  $t_P$  and  $t_L$  depending on  $DNT$  and  $\tau$ . Note that since profits of the final-good firm are non-negative (as  $w(\frac{\alpha}{1-\alpha}l_y - m_l) \geq 0$ ), the case where  $DNT < 0$  and  $\tau \geq 1$  can only occur if entrepreneurship is inefficient (i.e.  $\chi(L_B) < 1$ ) and/or  $s > 1$ .

Table 1: Median voter's preferred labor and profit tax rates, given  $\tau$  and  $L_B$

	$\tau \geq 1$	$\tau < 1$
$DNT \geq 0$	$t_L = \bar{t}$ , $t_P = 1 - \tau(1 - \bar{t})$	$t_L = 1 - (1 - \bar{t})/\tau$ , $t_P = \bar{t}$
$DNT < 0$	$t_L = 1 - (1 - \underline{t})/\tau$ , $t_P = \underline{t}$	$t_L = \underline{t}$ , $t_P = 1 - \tau(1 - \underline{t})$

We use  $\tilde{t}_L(\tau, L_B)$  and  $\tilde{t}_P(\tau, L_B)$  to refer to the optimal labor and profit tax rates for given  $\tau$  and  $L_B$ . Using these tax rates, we can write the net transfers, and consequently the median voter's income, as a continuous function of  $\tau$  and  $L_B$ .

**Lemma 4**

Using  $\tilde{t}_L(\tau, L_B)$  and  $\tilde{t}_P(\tau, L_B)$ , the median voter's income is a continuous function of  $(\tau, L_B)$  on  $[\underline{\tau}, \bar{\tau}] \times [0, \bar{L}]$ .

The proof is given in appendix C.10. Note that the median voter's income is not differentiable at the values of  $\tau$  and  $L_B$  where  $DNT = 0$ . With these results, we now move on to the second part of the median voter's maximization problem concerning the level of  $\tau$  and the amount of basic research investments. Using Lemma 4, the median

voter will seek the maximum of a continuous function over a compact set. Hence, by the Weierstrass extreme value theorem, the maximum will be attained in  $[\underline{\tau}, \bar{\tau}] \times [0, \bar{L}]$ . However, the set of maximizers may not be single-valued. For this purpose, it is instructive to discuss some properties of the median voter's income maximization problem by approaching it in the two-step procedure used in the main text.

Consider the optimization of the median voter's income (17) with respect to  $\tau$  for given basic research investments  $L_B$ :

$$\max_{\tau \in [\underline{\tau}, \bar{\tau}]} I(\tau, L_B) = w(\tau, L_B) \left[ 1 + s \left( \frac{\alpha}{1-\alpha} l_y(\tau, L_B) - m_l \right) \right] + NT(\tau, L_B) . \quad (\text{B.3})$$

Regarding a marginal increase in  $\tau$  at values of  $\tau$  (and  $L_B$ ), where  $DNT \neq 0$ , the median voter's income is affected as follows:<sup>59</sup>

$$\frac{dI(\tau, L_B)}{d\tau} = \frac{\partial NT}{\partial \tilde{t}_P} \frac{\partial \tilde{t}_P(\tau, L_B)}{\partial \tau} + \frac{\partial NT}{\partial \tilde{t}_L} \frac{\partial \tilde{t}_L(\tau, L_B)}{\partial \tau} + \frac{\partial I(\tau, L_B)}{\partial l_E} \frac{\partial l_E}{\partial \tau} . \quad (\text{B.4})$$

Note that for an interior solution  $\tau$  of the problem displayed in (B.3)  $\frac{dI(\tau, L_B)}{d\tau}$  must be zero, if it is not equal to the critical values of  $\tau$  associated with  $DNT = 0$ . An increase in  $\tau$  has two effects: it increases the relation between labor and profit taxes and it (weakly) increases the number of entrepreneurs. The first two summands in (B.4) reflect the decline of redistribution from profits to labor income due to the comparatively lower profit taxes. Note that one of the summands is zero, as either  $\tilde{t}_P$  or  $\tilde{t}_L$  remains at the boundary of the feasible set  $[\underline{t}, \bar{t}]$ . The last term in (B.4) captures the effect of an increase in the number of entrepreneurs on the median voter's income.<sup>60</sup> In the case where entrepreneurship is efficient, i.e.  $\chi(L_B) > 1$ , an increase in entrepreneurship will increase profits and total output but will lead to a lower wage rate. Consequently, a median voter with a small amount of stocks faces the following trade-off regarding  $\tau$ : On the one hand, a marginally higher level of  $\tau$  via a decline of  $t_P$  will lower her gross income (as the wage payments are the major income source) and lower the share of profits redistributed.<sup>61</sup> On the other, a larger  $\tau$  will increase total output and with it the tax base for profit tax. This reflects a standard Laffer-curve trade-off.

<sup>59</sup>Note that the terms  $\frac{\partial \tilde{t}_P(\tau, L_B)}{\partial \tau}$  and  $\frac{\partial \tilde{t}_L(\tau, L_B)}{\partial \tau}$  differ according to the different cases in Table 1. At the critical values  $\tau_c$ , as defined in the proof of Lemma 4, and  $\tau = 1$ , equation (B.4) can still be used when we refer to the right-sided derivatives.

<sup>60</sup>Note that for small values of  $L_B$  and  $\tau$ ,  $L_E$  will remain at zero in response to a marginal increase in  $\tau$ .

<sup>61</sup>Obviously, if  $\tau$  is increased via an increase of  $t_L$  rather than a decrease of  $t_P$ , a higher share of labor income is redistributed to entrepreneurs.

As the set of maximizers may contain several values for  $\tau$ , we cannot proceed as in section 5.2 and appendix A.1 by defining a function  $\tau(L_B)$ , inserting it back into the objective function, and then solving for the optimal value of  $L_B$ . Instead, we have to derive the correspondence  $L_B(\tau)$  that maximizes the median voter's income with respect to basic research investments for a given level of  $\tau$ . Optimal policy candidates for the median voter will lie in the intersection between the two correspondences  $\tau(L_B)$  and  $L_B(\tau)$ . Those with the highest income level will then constitute the median voter's preferred policies.

### B.3 Details on the numerical illustration

We consider an economy with population  $\bar{L} = 20$ , which represents the total labor force. To calibrate our model, we assume the following concave functional form for  $\eta(L_B)$ :  $\eta(L_B) = (L_B/\bar{L})^\beta$ . For a complete numerical specification, five parameter values need to be specified:  $\alpha$ ,  $\beta$ ,  $\gamma$ ,  $b$ , and  $m$ . We calibrate these parameters such that an entrepreneurial economy with positive basic research and entrepreneurship exhibits some average key characteristics of OECD member states observed from the data. We start by requiring that total investments in basic research amount to a share of 0.33% of GDP, which corresponds to the simple average of basic research intensities in OECD member states.<sup>62</sup> This yields the following condition:

$$(1 - \alpha) \frac{L_B}{L_y} = 0.0033 . \quad (\text{B.5})$$

Next we turn our attention to entrepreneurship. In our model entrepreneurship is innovative. We therefore choose  $L_E$  according to:

$$L_E = 0.0425\bar{L} , \quad (\text{B.6})$$

where 4.25% is the average share of the labor force engaged in opportunity-driven entrepreneurial activities.<sup>63</sup> We combine these requirements with information on output shares of intermediate goods and of labor to derive the standard production technology for intermediates in our economy. In particular, we follow Jones (2011) in requiring

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<sup>62</sup>*Source:* own calculations based on OECD (2012a). The data refers to centered 5-year moving averages in 2006 and was downloaded in June 2013.

<sup>63</sup>*Source:* own calculations based on Global Entrepreneurship Monitor (2013). The data refers to centered 5-year moving averages in 2006. The definition by GEM: 'improvement-driven opportunity entrepreneurial activity'. The data was downloaded in July 2013.

that in our entrepreneurial economy the output share of intermediates be 0.5. With all intermediates selling at price  $p(i) = mw$ , this corresponds to the following condition:

$$(1 - \alpha) \frac{m}{L_y} = 0.5 . \quad (\text{B.7})$$

Concerning labor income shares, we refer to data provided by the EU KLEMS project and require that:<sup>64,65</sup>

$$(1 - \alpha) \frac{L_y + L_x + L_B}{L_y + (1 - \alpha)L_B} = 0.628 . \quad (\text{B.8})$$

From the labor market clearing condition we obtain:

$$L_y + L_x + L_B = \bar{L} - L_E .$$

Combining this result with equations (B.5) to (B.8) and solving for  $m$ , yields:

$$m \approx 15.2 .$$

Next we require that output in the entrepreneurial economy be 5.7% larger than in the stagnant economy:<sup>66</sup>

$$\left[ \frac{L_y}{\bar{L} - m} \right]^{1-\alpha} = 1.057 . \quad (\text{B.9})$$

From equation (B.7) we can replace  $L_y$  by  $2m(1 - \alpha)$ , yielding:

$$\left[ \frac{2(1 - \alpha)m}{\bar{L} - m} \right]^{1-\alpha} = 1.057 .$$

With the solution for  $m$  given above, we can solve this equation numerically for  $\alpha$  to obtain:

$$\alpha \approx 0.79 .$$

We now turn to  $b$ ,  $\beta$ , and  $\gamma$ , the parameters characterizing entrepreneurship and innovation in our economy. We need three conditions to calibrate these parameters. An

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<sup>64</sup>*Source:* own calculations based on EU KLEMS (2011). The value of 0.628 is the average labor income share in OECD countries considered in the EU KLEMS database in year 2005 (centered 5-year moving averages have been used). The labor income share has been computed as  $\frac{\text{labor compensation}}{\text{labor compensation} + \text{capital compensation}}$ . The data was downloaded in July 2013.

<sup>65</sup>To mimic labor shares observed from the data, we add basic research investments to both labor income and final-good production when computing the labor share in our model, as basic research represents government expenditures. We note that using the labor share in the private sector alone,  $\frac{w[L_y + L_x]}{y}$ , would yield a very similar calibration.

<sup>66</sup>A 5.7% increase corresponds to the average total factor productivity growth for the OECD members included in the EU KLEMS database for the period 1996 to 2006. *Source:* own calculations based on EU KLEMS 2011. The data was downloaded in July 2013.

initial condition follows directly from the use of our previously derived results in the labor market clearing condition:

$$L_y = \bar{L} - L_B - m + L_E [\chi(L_B) - 1] . \quad (\text{B.10})$$

With the previous parameter values, this condition pins down the expected amount of labor savings by an additional entrepreneur,  $\chi(L_B)$ . Setting  $\tau = 1.01$ , which is in line with effective tax rates for OECD member countries,<sup>67</sup> we obtain the value for  $b \approx 2.31$  from the equilibrium condition for  $L_E$ :<sup>68</sup>

$$L_E = 1 - \frac{1}{\tau \chi(L_B) b} . \quad (\text{B.11})$$

Finally, we have to specify  $\beta$  and  $\gamma$ . Those parameter values are calculated to match both the value of  $\chi(L_B)$  derived previously and empirical evidence on mark-ups presented by Roeger (1995) and Martins et al. (1996). In line with this evidence, we require intermediate-good producers to charge on average a mark-up of 1.2, i.e. we require:

$$\frac{1}{\gamma} L_E \eta(L_B) = 1.2 .$$

This gives us the values  $\gamma \approx 0.16$  and  $\beta \approx 0.28$ .

## B.4 Alternative numerical illustrations

In this part of the appendix we report alternative numerical scenarios. In the main text we have argued that higher upper bounds on tax rates make it easier to align efficiency and equality in our economy, thereby increasing political support for growth-oriented entrepreneurial policies. We have illustrated this result with the numerical example shown in Figure 2.

Higher tax bounds increase political support for growth policies because they allow for a stronger redistribution of the gains from innovation. Of course, if the median voter has more shareholdings, then she has greater direct participation in the gains from innovation, and there is less need for redistribution via tax policies. Hence, as the shares of the median voter increase, she will support more growth-oriented policies for the same level of upper tax bounds  $\bar{t}$ . We illustrate this observation in Figures 3

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<sup>67</sup>Source: own calculations based on Djankov et al. (2010). The data was downloaded in April 2014.

<sup>68</sup>Note that this value for  $b$  implies that the aggregate immaterial utility from being an entrepreneur is positive, i.e. that, on average, entrepreneurs like being entrepreneurs, although some entrepreneurs dislike being entrepreneurs, in line with empirical evidence previously cited (cf. footnote 13).

Figure 3: Illustration of politically feasible entrepreneurial policies:  $s = 0$

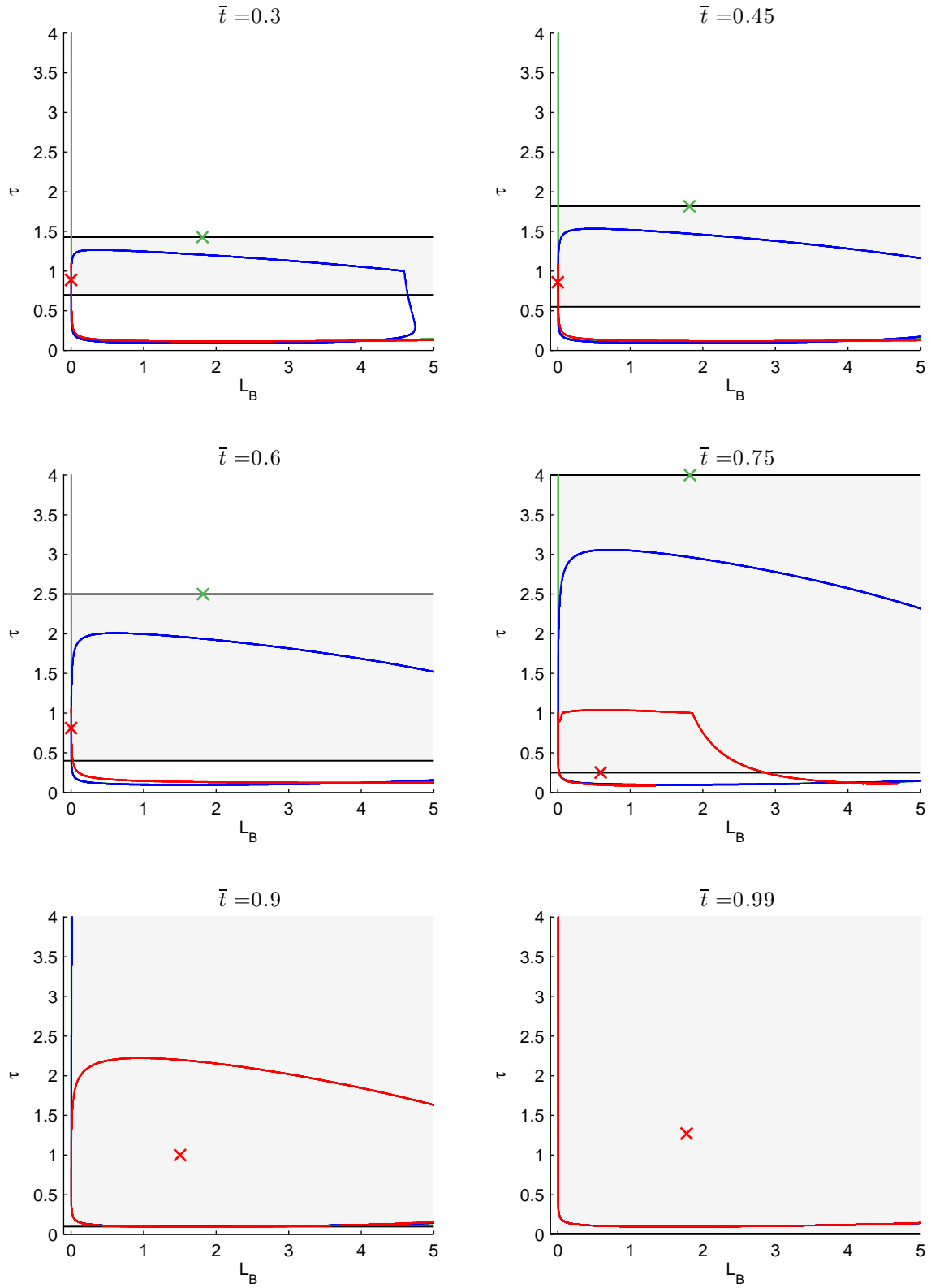
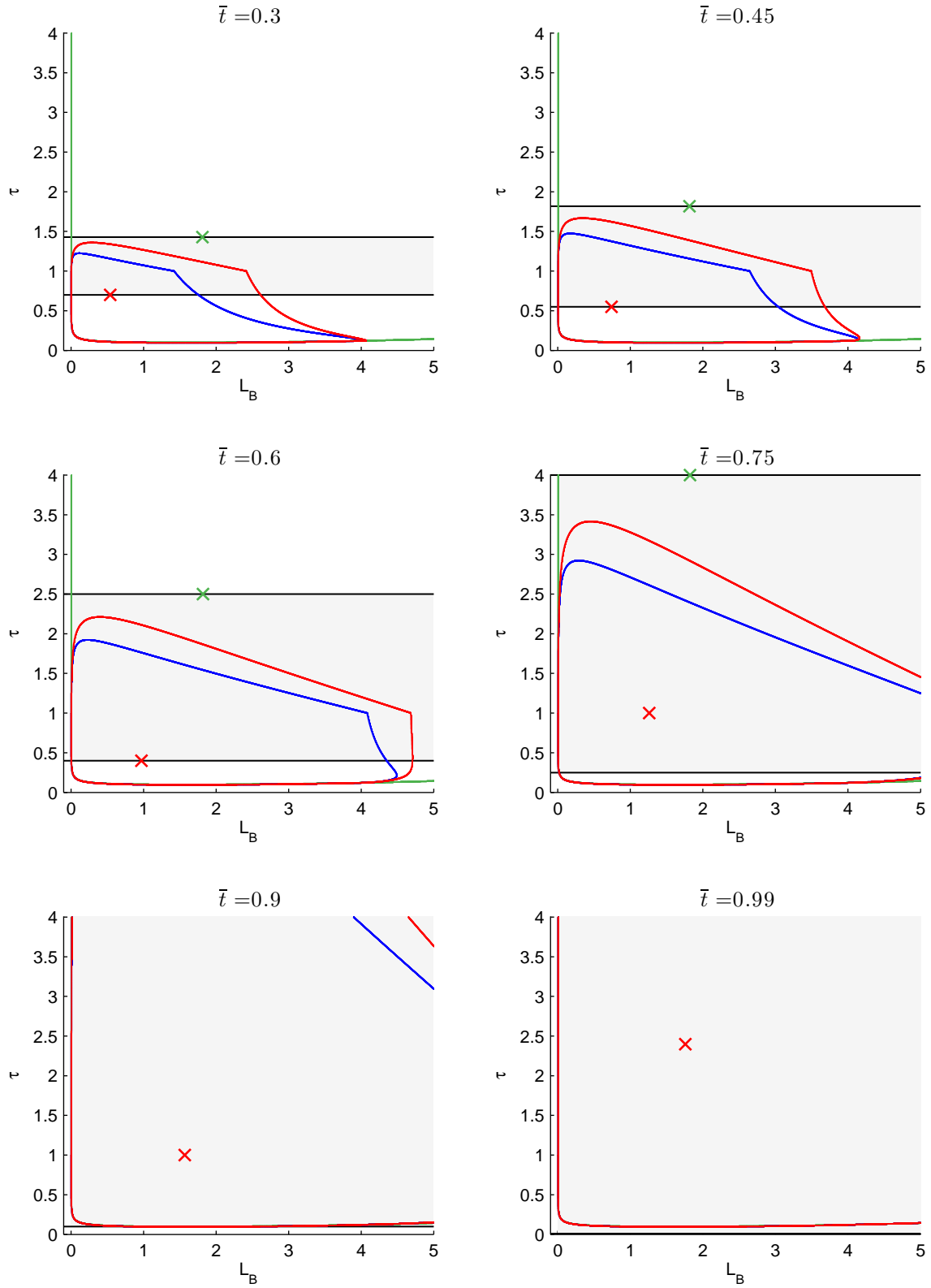


Figure 4: Illustration of politically feasible entrepreneurial policies:  $s = 1$



and 4, where we assume values of  $s = 0$  and  $s = 1$ , respectively. Indeed, a voter with no shares will only prefer some growth-oriented policy over the stagnant economy for high levels of  $\bar{t}$ . In fact, for low levels of  $\bar{t}$ , her most-preferred policy is an inefficient entrepreneurial policy, where aggregate output is lower than in the stagnant economy and thus wages are higher. By contrast, a voter with  $s = 1$  (i.e. a voter with per-capita shares) will prefer a broad range of growth-oriented entrepreneurial policies to the stagnant economy. Moreover, her most-preferred policy is one with growth-stimulating investments in basic research, even for very low levels of  $\bar{t}$ .

## B.5 Constitutional design

In this part of the appendix, we discuss constitutional design behind the veil of ignorance. Specifically, suppose that households decide on  $\bar{t}$  without knowing their individual shareholdings but only the distribution from which these shareholdings will be drawn. This distribution is the same for all households, i.e. households own the per-capita shares in expectation. For simplicity, suppose further that they are aware of their immaterial utilities from being an entrepreneur. Let  $\bar{L} > 2$ , i.e. let the majority of the population be workers. Then workers will choose  $\bar{t}$  to maximize their expected income under the policy preferred by the median voter.<sup>69</sup> As before, let  $s < 1$ , i.e. after the veil of ignorance has been resolved the median voter owns less than the per-capita shares. Then ex-ante workers will not care about the distribution of final-good producer's profits, only about aggregate income and the distribution thereof between workers and entrepreneurs. By contrast, the ex-post median voter will also care about distribution of final-good producer's profits. In essence, agents with (expected)  $s = 1$  set  $\bar{t}$  to guide the subsequent policy choice by a median voter with  $s < 1$ . In principle, we have to distinguish two cases, depending on whether or not the median voter with  $s \leq 1$  can earn  $\bar{y}_{opt}$ , the per-capita income in the output-maximizing entrepreneurial economy, or even more. We limit our attention to the more realistic case where this is not feasible.<sup>70</sup>

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<sup>69</sup>Recall that households are risk-neutral.

<sup>70</sup>If the median voter owns less than the per-capita shares of the final-good producer, she can only receive an income of  $\bar{y}_{opt}$  or more if entrepreneurs receive less income than workers on average (she can never have an income exceeding the average worker's income). Formally, we must have  $(1 - t_P)\chi(L_B)w < (1 - t_L)w$ , i.e. entrepreneurs are taxed sufficiently more heavily than workers such that net income is redistributed from entrepreneurs to workers. With  $\chi(L_B) > 1$  in any growth-oriented entrepreneurial economy, this requires  $\tau < 1$ , i.e. tax policies dis-incentivize entrepreneurship, so this economy is inefficient when compared to the output-maximizing economy yielding  $\bar{y}_{opt}$ . Hence, for the median voter to receive income larger than  $\bar{y}_{opt}$ , the redistribution of net income from entrepreneurs

Suppose  $\bar{t}$  is chosen arbitrarily close to 1 at the constitutional stage, i.e.  $\bar{t} = 1 - \varepsilon$  for some arbitrarily small  $\varepsilon > 0$ . Then, by choosing  $t_L, t_P$  arbitrarily close to 1 with  $t_L > t_P$ , the ex-post median voter can earn an income that is arbitrarily close to  $\bar{y}_{opt}$ . Given that it is not possible for her to earn  $\bar{y}_{opt}$ , she will implement this policy. This is ex-ante desired by the worker as it maximizes the cake and fully redistributes entrepreneurial profits. We conclude that in the constitutional design phase workers will choose  $\bar{t} = 1 - \varepsilon$ , the largest possible upper bound on taxation. As in Proposition 4, choosing  $\bar{t} = 1 - \varepsilon$  helps resolve the conflict between efficiency and equality. For  $\bar{t} = 1 - \varepsilon$ , the higher redistribution incentive for a voter with  $s < 1$  will not compromise efficiency.<sup>71</sup> The optimality of maximal constitutional freedom for tax policies adds a new perspective to the literature, which has hitherto emphasized constitutional tax constraints.<sup>72</sup>

## C Proofs

### C.1 Proof of Lemma 1

We prove each part of Lemma 1 separately.

(i) We consider innovative and non-innovative intermediate-good producers separately.

Intermediate goods in non-innovative industries are produced using the freely available standard technology. Perfect competition implies that these intermediate goods are sold at cost in equilibrium, i.e. non-innovative intermediate-good producers will offer their goods at price  $p(i) = mw$ .

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to workers must be large enough to overcompensate for the loss in efficiency arising from the decrease in productive entrepreneurship due to  $\tau < 1$ . If  $b$  is very large, this is possible in principle, as then the decrease in  $\tau$  has only a small negative effect on entrepreneurship. However, this may not be the most realistic scenario, and we therefore ignore it here.

<sup>71</sup>Note that this rationale also implies that in the constitutional design phase workers will choose  $\bar{t} = 1 - \varepsilon$ , the largest possible upper bound on taxation. The lower  $\bar{t}$  is, the more the median voter will compromise efficiency for more redistribution of the (final-good producer's) profits in her optimal policy choice.

<sup>72</sup>Cf. Brennan and Buchanan (1977) and Gradstein (1999) and the discussion in section 2. Note, however, that in our model  $\bar{t} = 1 - \varepsilon$  is no longer optimal in general if the ex-post median voter can receive income larger than  $\bar{y}_{opt}$  or if she holds  $s$  shares with  $s > 1$ . Then the median voter's ex-post interest in the redistribution of final-good producers' profits is different from the optimal solution for a worker with  $s = 1$ . Similarly, additional effects have to be taken into account if entrepreneurial talent is also behind the veil of ignorance in the constitutional stage. In this case, households care about maximizing aggregate welfare including the immaterial costs and benefits of being an entrepreneur (cf. section A.2) when choosing  $\bar{t}$ . Depending on parameter values,  $\bar{t} = 1 - \varepsilon$  may or may not be optimal in this case.

The production costs of innovative intermediate-good producers are reduced to  $\gamma mw$ . These firms are still confronted with competition from non-innovative intermediate-good producers in their industry. Taken together, this implies that an innovative intermediate-good producer will charge a price  $p(i) = \delta_i mw$  with  $\delta_i \in [\gamma, 1]$ . We show by contradiction that  $\delta_i \in [\gamma, 1)$  cannot be optimal. In particular, we show that no symmetric equilibria exist in which all innovative intermediate-good producers charge the common price  $p(i) = \delta mw$ , with  $\delta \in [\gamma, 1)$ .<sup>73</sup>

Let us define  $\tilde{X} := \int_{i|p(i)=\delta mw} x(i)^\alpha di$  and  $\hat{X} := \int_{i|p(i)=mw} x(i)^\alpha di$ . This enables us to write the maximization problem of the final-good producer as:

$$\begin{aligned} \max_{L_y, X} \pi_y &= L_y^{1-\alpha}(\tilde{X} + \hat{X}) - wL_y - \delta mw\tilde{X} - mw\hat{X} \\ &= \tilde{X}(L_y^{1-\alpha} - \delta mw) + \hat{X}(L_y^{1-\alpha} - mw) - wL_y. \end{aligned} \quad (\text{C.1})$$

As  $\delta < 1$ ,  $L_y^{1-\alpha} - \delta mw > 0$  is a necessary condition for non-negative profits for the final-good producer with positive output.  $L_y^{1-\alpha} - \delta mw$  is the net marginal benefit of the final-good producer from using intermediate good  $x(i)$  offered at price  $p(i) = \delta mw$  in production. Hence  $L_y^{1-\alpha} - \delta mw > 0$  implies first that if the final-good producer is operating, he will always demand  $x(i) = 1$  of every intermediate offered at price  $p(i) = \delta mw$ , and second, that the innovative intermediate-good producer  $i$  would want to set a price  $\tilde{p}(i) = \delta mw + \epsilon$ ,  $\epsilon > 0$  but small, such that  $L_y^{1-\alpha} - \tilde{p}(i) > 0$ . Then the net marginal benefit of the final-good producer from using intermediate good  $x(i)$  in production remains positive. Furthermore, given that each intermediate-good producer has measure 0, it would not affect the profitability of the representative final-good firm. Hence the final-good firm would still demand  $x(i) = 1$ , a contradiction to  $p(i) = \delta mw$  being profit-maximizing for intermediate-good producer  $i$ .

The contradiction establishes the result.

(ii) Let us define  $X := \int_0^1 x(i)^\alpha di$ .  $X$  assumes the value 0 if  $x(i) = 0 \forall i$ , 1 if  $x(i) = 1 \forall i$ , and values between 0 and 1 only if a subset of the varieties is used. If  $p(i) = mw \forall i$ , the maximization problem of the final-good producer can be written as:

$$\max_{L_y, X} \pi_y = L_y^{1-\alpha}X - wL_y - mwX = X(L_y^{1-\alpha} - mw) - wL_y. \quad (\text{C.2})$$

Hence the profit function is linear in  $X$ . A necessary condition for non-negative profits

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<sup>73</sup>It is straightforward to verify that no non-symmetric equilibrium exists with  $\delta_i < 1$  for any value of  $i$ .

is  $L_y^{1-\alpha} - mw > 0$ . Hence  $X = 1$  is profit-maximizing if the final-good producer is operating.

□

## C.2 Proof of Proposition 1

From Lemma 1 and the explanations in the main text we know that, if condition (PPC) is satisfied, the final-good producer is operating and using all varieties of the intermediate goods in production. Conversely, if condition (PPC) is not satisfied, he is not operating. From this follows  $L_E^e = L_x^e = L_y^e = 0$  and zero profits. We now need to show that in case (i) the other variables take on the unique equilibrium values stated in the Proposition.

(i) Conditions (1), (2), (4), and (7) have been derived in the main text. Condition (3) follows from using  $L_E^e$  and  $L_x^e$  in the labor market clearing condition. Combining  $w^e$  with the observation that  $p(i) = mw \forall i$  yields condition (5). Condition (6) follows from  $x(i) = 1 \forall i$  and the production technology in the final-good sector. Finally, condition (8) follows from using  $w^e$  in the expression for profits of a monopolistic intermediate-good producer.

□

## C.3 Proof of Corollary 1

By Proposition 3 there will be an entrepreneurial economy if and only if condition (PLS) is satisfied. In response to a change in  $m$ ,  $b$ ,  $\bar{\tau}$ , or  $\gamma$ , the government could leave  $\tilde{L}_B(\bar{\tau})$  unaffected. Hence, if it opts for a  $\hat{\tilde{L}}_B(\bar{\tau}) \neq \tilde{L}_B(\bar{\tau})$ , then we must have  $c(\bar{\tau}, \hat{\tilde{L}}_B(\bar{\tau})) \geq c(\bar{\tau}, \tilde{L}_B(\bar{\tau}))$ , which implies:

$$\begin{aligned} & -\hat{\tilde{L}}_B(\bar{\tau}) + \left[ 1 - \frac{1}{\bar{\tau}\chi(\hat{\tilde{L}}_B(\bar{\tau}))b} \right] \left[ \chi(\hat{\tilde{L}}_B(\bar{\tau})) - 1 \right] \geq \\ & -\tilde{L}_B(\bar{\tau}) + \left[ 1 - \frac{1}{\bar{\tau}\chi(\tilde{L}_B(\bar{\tau}))b} \right] \left[ \chi(\tilde{L}_B(\bar{\tau})) - 1 \right] . \end{aligned}$$

A proof then follows from the fact that for a given  $\tilde{L}_B(\bar{\tau})$ :

$$\left[ 1 - \frac{1}{\bar{\tau}\chi(\tilde{L}_B(\bar{\tau}))b} \right] \left[ \chi(\tilde{L}_B(\bar{\tau})) - 1 \right]$$

is increasing in  $m$ ,  $b$ , and  $\bar{\tau}$  and decreasing in  $\gamma$  as  $\chi(\tilde{L}_B(\bar{\tau})) = m(1 - \gamma)\eta(\tilde{L}_B(\bar{\tau}))$ .

□

## C.4 Proof of Proposition 4

By using (3), (4), and (6) from Proposition 1(i), income per capita can be written as:

$$\bar{y} := \frac{y}{\bar{L}} = w \left[ 1 + \frac{\alpha}{1 - \alpha} l_y - m_l + l_E(\chi(L_B) - 1) - l_B \right], \quad (\text{C.3})$$

where we use  $l_y := \frac{L_y}{\bar{L}}$ ,  $m_l := \frac{m}{\bar{L}}$ , and  $l_E := \frac{L_E}{\bar{L}}$  to denote per-capita variables. In the stagnant economy, this reduces to:

$$\bar{y}^S = \frac{y^S}{\bar{L}} = w^S \left[ 1 + \frac{\alpha}{1 - \alpha} l_y^S - m_l \right], \quad (\text{C.4})$$

where we use a superscript  $^S$  to denote variable values in the stagnant economy. Substituting (19) in (17), the value of the median voter's income is:

$$I = w \left[ 1 + \left( \frac{\alpha}{1 - \alpha} l_y - m_l \right) (s + t_P(1 - s)) + l_E(t_P\chi(L_B) - t_L) - l_B \right],$$

which reduces to:

$$I^S = w^S \left[ 1 + \left( \frac{\alpha}{1 - \alpha} l_y^S - m_l \right) (s + t_P^S(1 - s)) \right]$$

in the stagnant economy. Due to the assumption  $s < 1$ , the median voter maximally redistributes profits  $t_P^S = \bar{t}$  in the stagnant economy.<sup>74</sup>

Consider any policy  $(\hat{\tau}, \hat{L}_B)$  for which  $\hat{y} > \bar{y}^S$  (such a policy necessarily implies  $\hat{L}_B > 0$  and  $\hat{L}_E > 0$ ). With  $s < 1$ , we have a condition where  $I^S \leq \bar{y}^S$ . Hence it suffices to show that for  $(\hat{\tau}, \hat{L}_B)$  we can find a  $\bar{t}$  such that  $\hat{I} > \bar{y}^S$ . Note that  $\lim_{t_P \rightarrow 1, t_L \rightarrow 1} \hat{I} = \hat{y}$ . Since  $\hat{y} > \bar{y}^S$ , the assertion of Proposition 4 follows from the fact that for any  $\delta > 0$  we can find a pair  $(t_P, t_L) \ll (1, 1)$  yielding  $\hat{\tau}$  and satisfying  $\hat{y} - \hat{I} \leq \delta$ .

□

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<sup>74</sup>Note that labor tax does not affect the median voter's income in the stagnant economy as all individuals are workers. The population only differs with respect to their shareholdings in the final-good firm.

## C.5 Proof of Proposition 5

To show the result, note first that the restriction  $s \leq \frac{\bar{L}}{L+(1-\gamma)m}$  is a sufficient condition for the negative derivative of the median voter's gross income with respect to  $L_y$ . The restriction  $s \leq \frac{\bar{L}}{L+(1-\gamma)m}$  follows from the fact that  $L_y < \bar{L} - \gamma m$ .

Now suppose that  $\bar{t} = 0$ . Then the median voter's income corresponds to her gross income minus her share of the cost involved in providing basic research. In such circumstances, she will strictly prefer the stagnant economy over the entrepreneurial economy.<sup>75</sup> The result then follows from the continuity of the median voter's income, implying that she will also prefer the stagnant economy for sufficiently small  $\bar{t} > 0$ .

□

## C.6 Proof of Proposition 6

Fix any entrepreneurial policy  $(\hat{\tau}, \hat{L}_B)$  with  $\hat{L}_y \geq L_y^S$ . From Proposition 4 we know that for  $\bar{t} = 1 - \varepsilon$ , the following two conditions are satisfied:

1.  $\hat{\tau} \in [\underline{\tau}, \bar{\tau}]$ ,
2. the median voter with  $s \leq \frac{\bar{L}}{L+(1-\gamma)m}$  will prefer the entrepreneurial policy  $(\hat{\tau}, \hat{L}_B)$  over the stagnant economy.

From Proposition 5 we know that for  $\bar{t}$  small the median voter supports the stagnant economy, implying that at least one of the two conditions above is no longer satisfied. Accordingly, it remains to be shown that for every entrepreneurial policy  $(\hat{\tau}, \hat{L}_B)$  there exists a unique threshold level  $\bar{t}_c$  such that both conditions above are satisfied if and only if  $\bar{t} \geq \bar{t}_c$ .

For every  $\hat{\tau} \in (0, 1)$  there exists a unique  $\bar{t}_c^1$  such that  $\hat{\tau} \in [\underline{\tau}, \bar{\tau}]$  if and only if  $\bar{t} \geq \bar{t}_c^1$ . Hence we can limit our attention to  $\bar{t} \geq \bar{t}_c^1$ , and the result follows if we can show that  $\hat{I} - I^S$  is monotonic in  $\bar{t}$ .<sup>76</sup> Note that a decrease in  $\bar{t}$  such that  $\bar{t} \geq \bar{t}_c^1$  will only change net transfers but not the median voter's gross income. Thus we can limit our attention to the derivative of  $NT$  with respect to  $\bar{t}$  for  $\hat{\tau}$  and  $\hat{L}_B$  given. In the stagnant economy

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<sup>75</sup>Note that in the entrepreneurial economy  $L_y \geq L_y^S$  and  $L_B > 0$ .

<sup>76</sup>As we show below,  $\hat{I} - I^S$  can be monotonically increasing or decreasing. Obviously, if it is monotonically decreasing then we must have  $\bar{t}_c = \bar{t}_c^1$ .

we have:<sup>77</sup>

$$\frac{\partial NT^S}{\partial \bar{t}} = w^S \left[ \left( \frac{\alpha}{1-\alpha} l_y^S - m_l \right) (1-s) \right] \geq 0 .$$

Note that  $\frac{\partial NT^S}{\partial \bar{t}}$  is constant. The monotonicity of  $\hat{I} - I^S$  then follows from  $\frac{\partial NT}{\partial \bar{t}} \Big|_{\substack{\hat{L}_B \\ \bar{t} \geq \bar{t}_c^1}}^{\hat{\tau}}$  being constant as well. We will show that this holds for each of the four cases outlined in Table 1 of appendix B.2.

**$DNT < 0, \hat{\tau} \geq 1$**  Not possible as  $\hat{L}_y \geq L_y^S$  implies  $\chi(\hat{L}_B) > 1$  and  $s \leq \frac{\bar{L}}{\bar{L} + (1-\gamma)m} < 1$ .

**$DNT < 0, \hat{\tau} < 1$**  The median voter optimally chooses  $\hat{t}_L = \underline{t} = 0$  and  $\hat{t}_P = 1 - \hat{\tau}$  implying that:

$$\frac{\partial NT}{\partial \bar{t}} \Big|_{\substack{\hat{L}_B \\ \bar{t} \geq \bar{t}_c^1}}^{\hat{\tau}} = 0 ,$$

so  $\hat{I} - I^S$  is monotonically decreasing in  $\bar{t}$ .<sup>78</sup>

**$DNT \geq 0, \hat{\tau} \geq 1$**  The median voter optimally chooses  $\hat{t}_L = \bar{t}$  and  $\hat{t}_P = 1 - \hat{\tau}(1 - \bar{t})$ . Hence the derivative of net transfers in the entrepreneurial economy with respect to  $\bar{t}$  writes:

$$\frac{\partial NT}{\partial \bar{t}} \Big|_{\substack{\hat{L}_B \\ \bar{t} \geq \bar{t}_c^1}}^{\hat{\tau}} = \hat{w} \left[ \hat{\tau} \left( \left( \frac{\alpha}{1-\alpha} \hat{l}_y - m_l \right) (1-s) + \chi(\hat{L}_B) \hat{l}_E \right) - \hat{l}_E \right] ,$$

which is constant, implying that  $\hat{I} - I^S$  is monotonic in  $\bar{t}$ .<sup>79</sup>

**$DNT \geq 0, \hat{\tau} < 1$**  The median voter optimally chooses  $\hat{t}_L = 1 - (1 - \bar{t})/\hat{\tau}$  and  $\hat{t}_P = \bar{t}$ , yielding the following derivative of net transfers in the entrepreneurial economy:

$$\frac{\partial NT}{\partial \bar{t}} \Big|_{\substack{\hat{L}_B \\ \bar{t} \geq \bar{t}_c^1}}^{\hat{\tau}} = \hat{w} \left[ \left( \frac{\alpha}{1-\alpha} \hat{l}_y - m_l \right) (1-s) + \chi(\hat{L}_B) \hat{l}_E - \frac{\hat{l}_E}{\hat{\tau}} \right] .$$

Again,  $\frac{\partial NT}{\partial \bar{t}} \Big|_{\substack{\hat{L}_B \\ \bar{t} \geq \bar{t}_c^1}}^{\hat{\tau}}$  is constant, implying that  $\hat{I} - I^S$  is monotonic in  $\bar{t}$ . □

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<sup>77</sup>Note that we always have  $1 \in [\underline{t}, \bar{t}]$ . Hence, by Assumption 1, the stagnant economy is always feasible, irrespective of  $\bar{t}$ .

<sup>78</sup>Note that  $\frac{\partial NT}{\partial \bar{t}} \Big|_{\substack{\hat{L}_B \\ \bar{t} \geq \bar{t}_c^1}}^{\hat{\tau}} = 0$ ,  $\frac{\partial NT^S}{\partial \bar{t}} \geq 0$  and Proposition 4 imply that in the case considered here the median voter will prefer the entrepreneurial economy over the stagnant economy whenever both are feasible, i.e. we have  $\bar{t}_c = \bar{t}_c^1 = 1 - \hat{\tau}$ .

<sup>79</sup>In fact, we have  $\bar{t}_c > \bar{t}_c^1$ . This follows from  $t_P = 0$  and hence  $NT < 0$  for  $\hat{\tau} = \bar{\tau}$ . Note that this also implies that  $\hat{I} - I^S$  is monotonically increasing.

## C.7 Proof of Proposition 7

To prove Proposition 7, we need to show that  $\bar{\tau}_O(L_B)$  and  $\underline{\tau}_O(L_B)$  correspond to the taxation pecking orders described in the main text. We prove Proposition 7 (i) by contradiction. Part (ii) can be shown using a similar argument.

(i) We first note that  $L_B > L_{B,min}$  implies that if  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  satisfies condition (PPC), then so does any  $(t'_L, t'_P, \hat{L}_B)$  satisfying  $\frac{1-t'_P}{1-t'_L} \geq \frac{1-\hat{t}_P}{1-\hat{t}_L}$ .

Let  $TR(t_L, t_P, L_B)$  denote tax revenues in working hour equivalents given  $t_L$ ,  $t_P$ , and  $L_B$ . Consider a policy choice  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  that satisfies (PPC) with  $\hat{t}_P > 0$  and  $\hat{L}_B > L_{B,min}$ . Suppose there exists  $\hat{\hat{t}}_L > \hat{t}_L$  such that  $TR(\hat{\hat{t}}_L, \hat{t}_P, \hat{L}_B) > TR(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ . Then, by continuity of  $TR$  in  $t_L$  and  $t_P$ , it is possible to finance  $\hat{L}_B$  using some alternative financing scheme  $(t'_L, t'_P)$  satisfying:

$$\begin{aligned} t'_L &= \hat{t}_L + \Delta_1, \quad \Delta_1 \geq 0, \text{ but small enough for } t'_L \leq \bar{t}_L \\ t'_P &= \hat{t}_P - \Delta_2, \quad \Delta_2 \geq 0, \text{ but small enough for } t'_P \geq 0 \\ \frac{1-t'_P}{1-t'_L} &> \frac{1-\hat{t}_P}{1-\hat{t}_L}. \end{aligned}$$

In particular, depending on whether  $\frac{\partial TR}{\partial t_L}$  and  $\frac{\partial TR}{\partial t_P}$ , respectively, are smaller or larger than 0, the following alternative financing schemes satisfy the above conditions:

1. Suppose  $\frac{\partial TR}{\partial t_L} \Big|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} < 0$  or  $\left( \frac{\partial TR}{\partial t_L} \Big|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} = 0 \text{ and } \frac{\partial^2 TR}{(\partial t_L)^2} \Big|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} < 0 \right)$ . By our assumption there exists  $\hat{\hat{t}}_L > \hat{t}_L$  such that  $TR(\hat{\hat{t}}_L, \hat{t}_P, \hat{L}_B) > TR(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ . Then by continuity of  $TR$  in  $t_L$  there exists a  $t'_L > \hat{t}_L$  satisfying  $TR(t'_L, \hat{t}_P, \hat{L}_B) = TR(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ . We conclude that there exists  $\Delta_1 > 0$  and  $\Delta_2 = 0$  satisfying the conditions stated above.

2. Suppose  $\frac{\partial TR}{\partial t_P} \Big|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} < 0$  or  $\left( \frac{\partial TR}{\partial t_P} \Big|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} = 0 \text{ and } \frac{\partial^2 TR}{(\partial t_P)^2} \Big|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} > 0 \right)$ . We show that for given  $\hat{t}_L$  and  $\hat{L}_B$ ,  $TR$  is minimized at  $t_P = 0$ . Then it follows from continuity of  $TR$  in  $t_P$  that there exists a  $t'_P < \hat{t}_P$  satisfying  $TR(\hat{t}_L, t'_P, \hat{L}_B) = TR(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ . Hence there exist  $\Delta_1 = 0$  and  $\Delta_2 > 0$  satisfying the conditions stated above.

To show that  $TR$  is minimized at  $t_P = 0$  for given  $\hat{t}_L$  and  $\hat{L}_B$ , note first that

$L_E$  is non-increasing in  $t_P$ . Hence the term  $(\bar{L} - L_E)t_L$  is non-decreasing in  $t_P$ . Furthermore, all values  $t_P < \hat{t}_P$  satisfy condition (PPC), so we have:

$$t_P \left[ \frac{\alpha}{1-\alpha} L_y - m + L_E \chi(L_B) \right] \geq 0 .$$

We conclude that  $TR$  is indeed minimized at  $t_P = 0$  for given  $\hat{t}_L$  and  $\hat{L}_B$ .

$$3. \text{ Finally, suppose } \left. \frac{\partial TR}{\partial t_L} \right|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} > 0 \text{ or } \left( \left. \frac{\partial TR}{\partial t_L} \right|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} = 0 \text{ and } \left. \frac{\partial^2 TR}{(\partial t_L)^2} \right|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} > 0 \right)$$

and

$$\left. \frac{\partial TR}{\partial t_P} \right|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} > 0 \text{ or } \left( \left. \frac{\partial TR}{\partial t_P} \right|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} = 0 \text{ and } \left. \frac{\partial^2 TR}{(\partial t_P)^2} \right|_{\substack{t_L=\hat{t}_L \\ t_P=\hat{t}_P \\ L_B=\hat{L}_B}} < 0 \right).$$

Then by continuity of  $TR$  in  $t_L$  and  $t_P$  there exists a tax rate  $t'_L > \hat{t}_L$  and  $t'_P < \hat{t}_P$  satisfying  $TR(t'_L, t'_P, \hat{L}_B) = TR(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ . We conclude that there exist  $\Delta_1 > 0$  and  $\Delta_2 > 0$  satisfying the conditions stated above.

As  $\frac{1-t'_P}{1-t'_L} > \frac{1-\hat{t}_P}{1-\hat{t}_L}$ ,  $L'_E > \hat{L}_E$ .<sup>80</sup> Since  $\hat{L}_B > L_{B,min}$  and hence  $\chi(\hat{L}_B) > 1$ , it follows that  $L'_y > \hat{L}_y$ , a contradiction to  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  being optimal.

□

## C.8 Proof of Propositions 9 and 10

We prove an extended version of Proposition 10, also including relevant knife-edge cases. Proposition 9 follows immediately.

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<sup>80</sup>Note that it can never be optimal to finance  $L_B > 0$  when occupational choices would lead to  $L_E = 0$ .

### Proposition 12

The welfare-optimal tax policy can be characterized as follows:

	Case			Tax Policy
1	$L_E^* > 0$	-	-	$t_P^* = \underline{t}_P, t_P^* = \bar{t}_P, t_L^* = \underline{t}_L$ or $t_L^* = \bar{t}_L$
1.1		$1 - \frac{1}{b} - \frac{L_E^*}{2} > 0$	-	$t_P^* = \underline{t}_P$ and/or $t_L^* = \underline{t}_L$
1.1.1			$L_E^* > 1 - \frac{1-\underline{t}_L}{(1-\underline{t}_P)\chi(L_B^*)b}$	$t_P^* = \underline{t}_P$ and $t_L^* > \underline{t}_L$
1.1.2			$L_E^* = 1 - \frac{1-\underline{t}_L}{(1-\underline{t}_P)\chi(L_B^*)b}$	$t_P^* = \underline{t}_P$ and $t_L^* = \underline{t}_L$
1.1.3			$L_E^* < 1 - \frac{1-\underline{t}_L}{(1-\underline{t}_P)\chi(L_B^*)b}$	$t_P^* > \underline{t}_P$ and $t_L^* = \underline{t}_L$
1.2		$1 - \frac{1}{b} - \frac{L_E^*}{2} = 0$	-	$t_P^* = \underline{t}_P$ and $t_L^* = \bar{t}_L$ or $t_P^* = \bar{t}_P$ and $t_L^* = \underline{t}_L$
1.3		$1 - \frac{1}{b} - \frac{L_E^*}{2} < 0$	-	$t_P^* = \bar{t}_P$ and/or $t_L^* = \bar{t}_L$
1.3.1			$L_E^* > 1 - \frac{1-\bar{t}_L}{(1-\bar{t}_P)\chi(L_B^*)b}$	$t_P^* < \bar{t}_P$ and $t_L^* = \bar{t}_L$
1.3.2			$L_E^* = 1 - \frac{1-\bar{t}_L}{(1-\bar{t}_P)\chi(L_B^*)b}$	$t_P^* = \bar{t}_P$ and $t_L^* = \bar{t}_L$
1.3.3			$L_E^* < 1 - \frac{1-\bar{t}_L}{(1-\bar{t}_P)\chi(L_B^*)b}$	$t_P^* = \bar{t}_P$ and $t_L^* < \bar{t}_L$
2		$L_E^* = 0$	-	any feasible $t_L^*, t_P^*$ with $\frac{1-t_L^*}{(1-t_P^*)\chi(L_B^*)b} \geq 1$

#### C.8.1 Proof of Proposition 12: Part 1

Implied by Proposition 12.1.1-3.

#### C.8.2 Proof of Proposition 12: Part 1.1

We prove the result by contradiction.

$0 < L_E < 2(1 - \frac{1}{b})$  implies that the immaterial utility of entrepreneurs in aggregate welfare,  $(1 - t_P)\chi(L_B)(1 - \alpha)bL_y^{-\alpha}L_E [1 - \frac{1}{b} - \frac{L_E}{2}]$ , is positive. Now consider a policy choice  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  such that  $\hat{t}_L > \underline{t}_L$ ,  $\hat{t}_P > \underline{t}_P$  and  $\chi(\hat{L}_B)(2 - b) < \frac{1-\hat{t}_L}{1-\hat{t}_P} < \chi(\hat{L}_B)b$ , which is equivalent to  $0 < L_E < 2(1 - \frac{1}{b})$ . Then the following deviation is feasible:

$$\begin{aligned}
 t'_P &= \hat{t}_P - \Delta_1, \quad \Delta_1 > 0, \text{ but small enough for } t'_P \geq \underline{t}_P \\
 t'_L &= \hat{t}_L - \Delta_2, \quad \Delta_2 > 0, \text{ but small enough for } t'_L \geq \underline{t}_L \\
 L'_B &= \hat{L}_B,
 \end{aligned}$$

and where  $\Delta_1$  and  $\Delta_2$  are chosen to satisfy:

$$\frac{1 - \hat{t}_P}{1 - \hat{t}_L} = \frac{1 - t'_P}{1 - t'_L} .$$

Then  $L'_E = \hat{L}_E$ ,  $L'_y = \hat{L}_y$ , and hence  $W(t'_L, t'_P, L'_B) > W(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ , a contradiction to  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  being a welfare optimum. □

### C.8.3 Proof of Proposition 12: Parts 1.1.1, 1.1.2, 1.1.3

Immediately follow from Proposition 12.1.1.

### C.8.4 Proof of Proposition 12: Part 1.2

We prove the result by contradiction.

Consider a policy choice  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  such that  $0 < L_E = 2(1 - \frac{1}{b})$  and where  $\hat{t}_L$  and  $\hat{t}_P$  are not located at opposing boundaries of their respective feasible sets. Then it must be possible to either increase or decrease both tax measures,  $t_L$  and  $t_P$ . Furthermore, for  $L_E = 2(1 - \frac{1}{b})$ , the following relationship between the partial derivatives of  $W$  with respect to  $t_L$ ,  $t_P$ , and  $L_E$  holds:

$$\frac{\partial W}{\partial t_P} = -\frac{\partial W}{\partial t_L} \frac{1}{\tau} = -\frac{\partial W}{\partial L_E} \frac{1 - t_L}{(1 - t_P)^2 \chi(L_B) b} .$$

As a consequence,  $\frac{\partial W}{\partial L_E} \Big|_{\substack{\hat{t}_L \\ \hat{t}_P \\ \hat{L}_B}} = 0$  is a necessary condition for  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  to be a welfare optimum. Using  $\hat{L}_E = 2(1 - \frac{1}{b})$ ,  $\frac{\partial W}{\partial L_E}$  reduces to:

$$\frac{\partial W}{\partial L_E} \Big|_{\substack{\hat{t}_L \\ \hat{t}_P \\ \hat{L}_B}} = (1 - \alpha) L_y^{-\alpha} \left[ (\chi(\hat{L}_B) - 1) - (1 - \hat{t}_P) \chi(\hat{L}_B) (b - 1) \right] . \quad (\text{C.5})$$

Next, consider the following deviation:

$$\begin{aligned} t'_P &= \hat{t}_P + \Delta_1, & \Delta_1 &\neq 0, \text{ but small enough for } \underline{t}_P \leq t'_P \leq \bar{t}_P \\ t'_L &= \hat{t}_L + \Delta_2, & \Delta_2 &\neq 0, \text{ but small enough for } \underline{t}_L < t'_L < \bar{t}_L \\ L'_B &= \hat{L}_B, \end{aligned}$$

i.e.  $t'_L$  and  $t'_P$  are not located at opposing boundaries of there feasible sets, and where  $\Delta_1$  and  $\Delta_2$  are chosen to satisfy:<sup>81</sup>

$$\frac{1 - \hat{t}_P}{1 - \hat{t}_L} = \frac{1 - t'_P}{1 - t'_L} .$$

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<sup>81</sup>Note that by  $\bar{t}_j \leq 1 - \varepsilon$ ,  $j \in \{L, P\}$  we have  $\frac{1 - \hat{t}_P}{1 - \hat{t}_L} \in (0, \infty)$ .

Then  $L'_E = \hat{L}_E$ ,  $L'_y = \hat{L}_y$ , and hence  $W(t'_L, t'_P, L'_B) = W(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ , i.e. if  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  is a welfare optimum, so is  $(t'_L, t'_P, L'_B)$ . Now  $\hat{L}_E = 2(1 - \frac{1}{b}) > 0$  implies that  $b > 1$ . Hence, we know from equation (C.5) that if  $\frac{\partial W}{\partial L_E} \Big|_{\substack{\hat{t}_L \\ \hat{t}_P, \\ \hat{L}_B}} = 0$ , then  $\frac{\partial W}{\partial L_E} \Big|_{\substack{t'_L \\ t'_P \\ L'_B}} \neq 0$  must hold.

This is a contradiction to  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  being a welfare optimum. □

### C.8.5 Proof of Proposition 12: Part 1.3

We prove the result by contradiction.

With  $L_E > \max \{0, 2(1 - \frac{1}{b})\}$ , the immaterial utility of entrepreneurs in the aggregate welfare,  $(1 - t_P)\chi(L_B)(1 - \alpha)bL_y^{-\alpha}L_E \left[1 - \frac{1}{b} - \frac{L_E}{2}\right]$ , is negative. Now consider a policy choice  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  such that  $\hat{t}_L < \bar{t}_L$ ,  $\hat{t}_P < \bar{t}_P$ , and  $\frac{1 - \hat{t}_L}{1 - \hat{t}_P} < \min \left\{ \chi(\hat{L}_B)b, \chi(\hat{L}_B)(2 - b) \right\}$ , which is equivalent to  $L_E > \max \{0, 2(1 - \frac{1}{b})\}$ . Then the following policy choice is feasible:

$$\begin{aligned} t'_P &= \hat{t}_P + \Delta_1, \quad \Delta_1 > 0, \text{ but small such that } t'_P \leq \bar{t}_P \\ t'_L &= \hat{t}_L + \Delta_2, \quad \Delta_2 > 0, \text{ but small such that } t'_L \leq \bar{t}_L \\ L'_B &= \hat{L}_B, \end{aligned}$$

where  $\Delta_1$  and  $\Delta_2$  are chosen to satisfy:

$$\frac{1 - \hat{t}_P}{1 - \hat{t}_L} = \frac{1 - t'_P}{1 - t'_L}.$$

Then  $L'_E = \hat{L}_E$ ,  $L'_y = \hat{L}_y$ , and hence  $W(t'_L, t'_P, L'_B) > W(\hat{t}_L, \hat{t}_P, \hat{L}_B)$ , a contradiction to  $(\hat{t}_L, \hat{t}_P, \hat{L}_B)$  being a welfare optimum. □

### C.8.6 Proof of Proposition 12: Parts 1.3.1, 1.3.2, 1.3.3

Immediately follow from Proposition 12.1.3.

### C.8.7 Proof of Proposition 12: Part 2

For  $L_E^* = 0$ , all tax policies associated with  $L_E = 0$  are welfare-optimal, i.e. all tax policies satisfying  $\frac{1 - t_L}{(1 - t_P)\chi(L_B^*)b} \geq 1$ . This proves the last row in Proposition 12. □

## C.9 Proof of Proposition 11

For  $L_E = 0$ ,  $W$  does not depend on the choice of  $t_L$  and  $t_P$ . Hence,  $L_E > 0$  is optimal if there exists a tax policy,  $\hat{t}_L$  and  $\hat{t}_P$  such that  $L_E$  is just equal to 0, i.e.  $1 - \frac{1-\hat{t}_L}{(1-\hat{t}_P)\chi(L_B^*)b} = 0$ , and  $\left. \frac{\partial W}{\partial L_E} \right|_{\hat{t}_L, \hat{t}_P} > 0$ . In what follows we show that this is the case if and only if the condition stated in Proposition 11 is satisfied.

Differentiating  $W$  with respect to  $L_E$  yields:

$$\begin{aligned} \frac{\partial W}{\partial L_E} = & (1-\alpha)L_y^{-\alpha} \left\{ (\chi(L_B^*) - 1) + (1-t_P)\chi(L_B^*)b \right. \\ & \left. \left[ \left(1 - \frac{1}{b} - L_E\right) - \alpha(\chi(L_B^*) - 1)L_y^{-1} \left(1 - \frac{1}{b} - \frac{L_E}{2}\right) L_E \right] \right\} . \end{aligned}$$

Evaluated at  $L_E = 0$ , this reduces to:

$$\left. \frac{\partial W}{\partial L_E} \right|_{L_E=0} = (1-\alpha) (\bar{L} - L_B^* - m)^{-\alpha} [\chi(L_B^*) - 1 + (1-t_P)\chi(L_B^*)(b-1)] .$$

The non-negativity condition for profits in the final-good producer combined with the feasibility of  $L_E = 0$  imply that  $\bar{L} - L_B^* \geq \frac{m}{\alpha}$  and hence  $(\bar{L} - L_B^* - m) > 0$ . We conclude:

$$\left. \frac{\partial W}{\partial L_E} \right|_{L_E=0} > 0 \quad \text{if and only if} \quad \chi(L_B^*) > \frac{1}{1 + (1-t_P)(b-1)} .$$

Whether or not  $\left. \frac{\partial W}{\partial L_E} \right|_{L_E=0} > 0$  depends on the choice of  $t_P$ . In particular, for  $(\bar{L} - L_B^* - m) > 0$ :

$$\left. \frac{\partial W}{\partial L_E} \right|_{L_E=0} \text{ is } \begin{cases} \text{increasing in } t_P & \text{if } b < 1 \\ \text{independent of } t_P & \text{if } b = 1 \\ \text{decreasing in } t_P & \text{if } b > 1 \end{cases} .$$

We conclude that for  $b \leq 1$ ,  $\frac{\partial W}{\partial L_E} > 0$  for some choice of  $t_L$  and  $t_P$  satisfying  $1 - \frac{1-t_L}{(1-t_P)\chi(L_B^*)b} = 0$  if and only if  $\chi(L_B^*) > \frac{1}{1+(1-t_P)(b-1)}$  for the largest possible  $t_P$  satisfying  $1 - \frac{1-t_L}{(1-t_P)\chi(L_B^*)b} = 0$ . Conversely, if  $b > 1$ ,  $\frac{\partial W}{\partial L_E} > 0$  for some choice of  $t_L$  and  $t_P$  satisfying  $1 - \frac{1-t_L}{(1-t_P)\chi(L_B^*)b} = 0$  if and only if  $\chi(L_B^*) > \frac{1}{1+(1-t_P)(b-1)}$  for the smallest possible  $t_P$  satisfying  $1 - \frac{1-t_L}{(1-t_P)\chi(L_B^*)b} = 0$ .  $\tilde{t}_P$  in condition (A.7) has been chosen accordingly.  $\square$

## C.10 Proof of Lemma 4

We first show the continuity of the median voter's income  $I$  with respect to  $\tau$ , for given  $L_B$ , and then the continuity of  $I$  with respect to  $L_B$ , for given  $\tau$ .

(1) Since the median voter's gross income is a continuous function of  $\tau$  and  $L_B$ , it is sufficient to focus on net transfers  $NT(\tau, L_B)$ .

(2) We use Table 1, which describes optimal labor and profit taxes for given  $(\tau, L_B)$ . We observe that the net transfers are continuous within each of the different subsets of  $(\tau, L_B)$  defined by the four different cases. Potential discontinuities may exist at the transitions from one case to another. In this respect, we define the critical values  $\tau^c(L_B)$  and  $L_B^c(\tau)$  by  $DNT(\tau^c, L_B) = 0$  for a given  $L_B$  in the feasible set and by  $DNT(\tau, L_B^c) = 0$  for a given  $\tau$ , respectively.

(3) As can be observed from Table 1, there are two critical values of  $\tau$  for a given  $L_B$ :  $\tau^c(L_B)$  and  $\tau = 1$ . The former is only interesting if  $\tau^c(L_B) \in [\underline{\tau}, \bar{\tau}]$ , while by our assumptions in section 4 the latter will always be in the feasible set. Now consider any two sequences  $\{\tau_m\}$  and  $\{\tau_n\}$  with  $\lim_{m \rightarrow \infty} \tau_m = \tau^c$ ,  $\tau_m \leq \tau^c$ , and  $\lim_{n \rightarrow \infty} \tau_n = \tau^c$ ,  $\tau_n \geq \tau^c$ . As  $DNT(\tau^c, L_B) = 0$  means that a change in tax rates  $t_P, t_L$  does not affect net transfers  $[NT(\tau^c, L_B)]$  as long as  $\tau^c$  remains unchanged, we must obtain  $\lim_{m \rightarrow \infty} NT(\tau_m, L_B) = \lim_{n \rightarrow \infty} NT(\tau_n, L_B)$ . Hence,  $NT(\tau, L_B)$  is continuous at  $\tau^c$  for a given  $L_B$ .

(4) At the critical value  $\tau = 1$ , both tax rates  $t_P$  and  $t_L$  are identical. Consequently, for two sequences with  $\lim_{m \rightarrow \infty} \tau_m = 1$ ,  $\tau_m \leq 1$ , and  $\lim_{n \rightarrow \infty} \tau_n = 1$ ,  $\tau_n \geq 1$ , we also obtain  $\lim_{m \rightarrow \infty} NT(\tau_m, L_B) = \lim_{n \rightarrow \infty} NT(\tau_n, L_B) = NT(1, L_B)$ . Thus, net transfers are continuous in  $\tau$  at  $\tau = 1$ .

(5) We can use the same argument as in (3) with respect to sequences  $\{L_{B,m}\}$  and  $\{L_{B,n}\}$  with limit  $L_B^c$  for given  $\tau$  to establish continuity of  $I$  with respect to  $L_B$ .

□

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