

# Risk Markups

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## Abstract

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