

# Distinguishing Limited Liability from Moral Hazard in a Model of Entrepreneurship

---

Anna L. Paulson

*Federal Reserve Bank of Chicago*

Robert M. Townsend

*University of Chicago and Federal Reserve Bank of Chicago*

Alexander Karaivanov

*Simon Fraser University*

We present and estimate a model in which the choice between entrepreneurship and wage work may be influenced by financial market imperfections. The model allows for limited liability, moral hazard, and a combination of both constraints. The paper uses structural techniques to estimate the model and identify the source of financial market imperfections using data from rural and semiurban households in Thailand. Structural, nonparametric, and reduced-form estimates provide independent evidence that the dominant source of credit market imperfections is moral hazard. We reject the hypothesis that limited liability alone can explain the data.

A previous version of this paper has been circulated under the title "Distinguishing Limited Commitment from Moral Hazard in Models of Growth with Inequality." Comments from Daron Acemoglu, Patrick Bolton, Lars Hansen, Boyan Jovanovic, Andreas Lehnert, Bernard Salanié, Chris Udry, two anonymous referees, the editor of this *Journal*, and conference and seminar participants at the Federal Reserve Bank of Chicago, DELTA, Indiana University–Purdue University at Indianapolis, Massachusetts Institute of Technology, University of California at Los Angeles, University of Toulouse, Stanford, and Yale are gratefully acknowledged. We also thank Francisco Buera, Xavier Giné, and Yukio Koriyama for excellent research assistance as well as the National Institutes of Health and the National Science Foundation for funding. We are much indebted to Sombat Sakuntasathien for collaboration and for making the data collection possible. The views expressed in this paper are those of the authors and do not necessarily represent those of the Federal Reserve Bank of Chicago or the Federal Reserve System. The usual disclaimer applies.

[*Journal of Political Economy*, 2006, vol. 114, no. 1]  
© 2006 by The University of Chicago. All rights reserved. 3022-3828/2006/1140-0004\$10.00