OCCUPATIONAL CHOICE THEORY

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1. Dualism and Lewis Model

The idea of a dual sector economy with interlinkages goes back to the Lewis model as set out in Lewis (2000). The two sector have interlinkages and coexist within the same economy. The two sectors can be thought of as formal and informal sector, agrarian and manufacturing or traditional and modern sectors.

One way to interpret this is that modern sector has strong complementarities between the capital and labour, where the traditional sector's production lacks this complementarities. Recall the concept of the *quality ladder*.[1] As you go up the quality ladder, you require more specialised capital and more specialised labour with complementarities increasing as you go up the ladder. An economy's ability to get new industries depends on whether it has sufficient skilled labour than can be matched with the specialised capital. The supply constraint on specialised capital is less of a concern than the lack of sufficient skilled labour within the economy. Lewis model presumed the existence of modern sector but Galor and Zeira (1993) shows us that there are reasons why the modern sector may not develop automatically due to credit market imperfections.

The institutional arrangement in the traditional sector is such that the workers shared their output[2] The modern sector has a labour market and the workers in this sector obtain their marginal product of capital. Effectively, the compensation in the modern sector are high and the wages in the agricultural sector is low. The traditional sector also has a unlimited supply of labour once the wage in the modern sector crosses some threshold. The threshold of course depends on the friction that workers face moving from one sector to another sector. Labour moving from the traditional to the modern sector would increase the output of the economy if the marginal product of labour in the modern sector is higher than the marginal product of labour in the traditional sector.

[1] See Lucas Jr (1993).

[2] think of this as some kinds of a institutional arrangement like kin system. Hoff and Sen (2005) have explored this idea in terms of a kin system and shown how this under certain conditions can lead to communities being caught in a poverty trap.

2. Recent Occupational Choice Literature

Galor and Zeira (1993) and Banerjee and Newman (1993) are the two papers that started the revived interest in occupational choice theory and started the current literature in this area. The intuition of these papers and the rest of the literature is that the presence of credit market imperfections, the current distribution of wealth will determine the proportion of credit-constrained individuals in the economy, which in turn may affect equilibrium returns to various occupations in a way that affects the future wealth distribution through intergenerational transfers. As a result, the transition of the wealth distribution for the economy as a whole may turn out to be quite non-linear and complex with multiple equilibria. Papers that have picked up these ideas and extended them are papers like Ghatak and Nien-Huei Jiang (2002), Ghatak et al. (2001), Piketty (1997) and Aghion and Bolton (1997). Burgess and Besley (2004) is an excellent sources that describes the reason why formal and informal sector exists in the developing country. The papers empirically examines how the two sectors have been effected by the changes in state level labour laws within India since 1950.

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