Market size, entrepreneurship, sorting,

and income inequality

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April 8, 2015

**Abstract**

We develop a model in which heterogeneous agents self-select into entrepreneurship

and choose locations. When the ability distribution in cities is fixed the effect of market size

on the ratio of entrepreneurs to workers, and on income inequality, crucially hinges on two

properties of the lower-tier utility function: its elasticity of substitution and its Arrow-Pratt

index of relative risk aversion. When the ability distribution in cities is no longer fixed, we

show how simple complementarities between entrepreneurs and workers yield two-sided

sorting equilibria where the most skilled and the least skilled agents locate in a very unequal

city, whereas the intermediate types form a more equal city. Sorting across cities exacerbates

within and between city inequalities.

**Keywords:** market size; entrepreneurship; sorting; income inequality.

**JEL classification:** D31; D43; L11; L26

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