House Money and Entrepreneurship
Kerr, Kerr, and Nanda

Some comments…

What do they do?

- Correlate in a X-section the increase in house price at the zip code of the residence (2000-2004)* imputed value of the house in 2004 with the surviving + new number of entrepreneurs (2000-2004)

  – control for zip fixed effects

The Novelties

- Individual house values (albeit imputed to 2004 from 2000 Census)
- Control for fixed effects at the same geolocation aggregation as the house price increase
  - Possible due to the interaction b/w price increase * house value
- Consider carefully the difference between how windfall gains to the house equity affects entrepreneurship through the "collateral channel" versus "wealth effects"
  - Collateral channel effect is one where liquidity constraints are reduced thus providing greater business operating efficiency for entrants inducing entry (Evans and Jovanovic, 1989).
  - "Wealth effect". Those who could not fund a poor idea are suddenly able to, and some of those will thus enter. Could be due to many things, such as optimism or overconfidence.

Results

- Positive, statistically significant, but small effects of house price increases
  - $60,000 increase in house value (25th to 75th percentile) is associated with a 0.3 percentage points higher net entry rate, which is 6.7 p.p at the mean, or a 4.4% increase in net entrepreneurship
- The collateral effect seems not to dominate in two tests
- Once controlling at a more aggregate geo-level, there is a substantial renter's effect
- If anything, it seems that wealth effects are mostly the culprit. That's new.

Praise

- Several novelties as noted
- Huge dataset
- Significant data merging effort
- Thought "one step further"
- Wonderfully efficient prose

Quibbles

- Prose sometimes too terse…
  - Could not understand how the sample was created from business entered since 1995. Is this entrepreneurs in all firms created between 1995 and 2004?
  - Why not focus on entrants in 2004 only? Should be a lot cleaner in terms of Granger causality…
- Some odd data choices
  - Could not see the reason for why to study *net* "entrepreneurs", the sum of survivors from 1975 to 2000 and new entrants 2000-2004. Combine a study of mostly survival in entrepreneurship with a smaller fraction of new entrants.
    - Why should survival be affected by windfall personal wealth? If the business is doing poorly windfalls can indeed prolong survival. This is a wealth effect but not an obvious collateral effect.
    - Survivor bias. The poor ideas and the capital constrained die quickly. The good ideas grow out of capital constraints reasonably quickly. This leaves those which may not require additional capital in 2004. This will bias down the collateral channel effect.
    - Survivors enter between 1995-2003 (if I understand correctly.) That's the period before and during house price increases are measured. The idea of inferring Granger causality is gone.
  - The authors indeed find that the relative effect for incumbent survival is 0.7% and it is imprecisely measured while 5% for "new" entrepreneurs.
  - So probably a good idea to drop survivors up to 2000

Quibbles

- Weak definition of entrepreneurs
  - Anyone newly employed in a firm entering after 1995
  - This introduces noise, many people classified as entrepreneurs are simply employed and these are less likely to need to invest any house money
  - This will bias down any estimate of the correlation between entry and home equity
  - Ok if you say that your estimate is a lower bound, more troubling if you are trying to make a point out of the small size of the estimate

Suggestions

- The authors currently use two tests for the collateral channel
  - Differences in capital requirements across industries
  - Differences in personal bankruptcy exemptions (withholding homestead) across states
- May also look at
  - Differences in bank concentration ratios (or other bank behavior) across local bank markets (see Kerr and Nanda, 2009)

Suggestions

- The collateral channel effects are likely different from wealth effects in terms of business outcomes (but not survival)
  - Wealth effects should increase entry and possibly also investments (due to optimism or overconfidence), but should decrease gross profits and reduce retained earnings, since entry is to satisfy other things than profit maximizing. It should induce entry of poorer performing entrepreneurs
    - see Åstebro and Thompson (2011) who illustrate these effects for a taste for entrepreneurship and Gianetti and Simonov (1989) for similar results looking at the effect of social influence
  - For the collateral channel effect (i.e. a reduction of liquidity constraints) it should a) increase entry b) investments, c) gross profits and d) retained earnings.
    - Evans and Jovanovic (1989) provide proofs and some evidence on retained earnings.

Interpretation Suggestions

- There is a substantial renter's effect when using wider fixed geo-codes
- The authors suggest that renters may be "irrationally encouraged" to enter if they believe themselves wealthier due to rising home prices around them
- Renters are probably rationally entering locally as they see local house value go up (as their rent is going up). Local wealth is going up, people have more money to buy pizza, cleaning help, and handiwork locally.
  - Reasonable to look at start-ups across industries more or less affected by local demand. Pizza places versus biotech. This should provide some wedge to "kill" local demand effects

Summary

- Difficult to make a big point out of the "small effect" since it is currently likely to be downwards biased for several reasons
- Some simple changes to the sample will make the analysis more convincing in terms of Granger causality
- Hard to do anything about the imprecise measure of who is an entrepreneur
- Hopefully some additional test focusing on *bank behaviour* will isolate better the collateral channel vs wealth effect

What did we learn?

- We have known for some time that there are "wealth constraints" (e.g. EJ, 1989)
  - We have started to doubt whether this implies credit constraints
  - We have rejected studies showing lottery gains affecting entry rates as evidence of credit constraints
  - We now use increases in house prices and claim these show credit constraints, a.k.a. "the collateral channel"
- Even a clear exogenous shock in house prices will not cleanly separate credit constraints from "wealth effects" – BRAVO!

What would be the ideal experiment?

- In EJ credit constraints are indicated by λ, how much banks are willing to lend for 1$ collateral. In EJ, λ=0.40.

- CURRENT: "Exogenous" variations in C, where investment = C*λ

- BUT: Variations in C on entry can also mean other things, as we learned

- IDEAL: Exogenous variations in λ driving entry, investments, profits, and retained earning